Supreme Court, U.S.
FILED

10-693 NOV 22 2010

OFFICE OF THE CLERK

No.

In the

Supreme Court of the United States

ERNST & YOUNG LLP, et al.,

Petitioners,

v.

SHARON P. CLARK,
Commissioner for the Kentucky Department of Insurance and Rehabilitator of AIK Comp, et al.,

Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of Kentucky

PETITION FOR WRIT OF CERTIORARI

BRUCE M. CORMIER
Associate General Counsel
ERNST & YOUNG LLP
1101 New York Ave. NW
Washington, DC 20005
(202) 327-7603

PAUL D. CLEMENT
Counsel of Record
JOHN A. CHANDLER
ZACHARY D. TRIPP
KING & SPALDING LLP
1700 Pennsylvania Ave. NW
Washington, DC 20006
pclement@kslaw.com
(202) 737-0500

Counsel for Petitioners

November 22, 2010

QUESTION PRESENTED

Whether the Federal Arbitration Act, 9 U.S.C. § 2, is "reverse preempted" by the McCarran-Ferguson Act, 15 U.S.C. § 1012(b), such that state law vitiates an arbitration agreement covering an ordinary tort suit between the rehabilitator of an insolvent insurer and an auditor?

PARTIES TO THE PROCEEDING

Petitioners in this Court, defendants-appellants below, are Ernst & Young LLP and David S. Meyer. Respondents in this Court, plaintiffs-appellees below, are Sharon P. Clark, in her official capacity as Commissioner for the Kentucky Department of Insurance and Rehabilitator of AIK Comp; Stephen P. Lattanzio; Actuarial & Technical Solutions, Inc.; and John and Jane Does, all unknown actuaries and accountants.

Appalachian Regional Healthcare, Inc.; Apollo Oil, LLP; Art's Electric, Inc.; Crittenden Health Systems; European Design, Inc.; Fischer Special Manufacturing Co.; Gallatin Health Care, LLC; Hopewell Farm, LLC; Louden & Co., LLC; M & M Cartage, Inc.; Modco Transport; and Pattie A. Clay Regional Medical Center were parties to a separate suit, which was consolidated in the Kentucky Supreme Court proceedings below. Petitioners do not seek this Court's review of the judgment in that case.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, petitioner Ernst & Young LLP states that it has no parent corporation and that no publicly held corporation owns 10% or more of Ernst & Young LLP.

TABLE OF CONTENTS

QUESTION PRESENTED i

PARTIES TO THE PROCEEDING ii

CORPORATE DISCLOSURE STATEMENT ii

TABLE OF AUTHORITIES vi

OPINIONS BELOW 1

JURISDICTION 1

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED 1

STATEMENT OF THE CASE 3

A. Factual Background 4

B. Statutory Framework 6

C. Procedural History 9

REASONS FOR GRANTING THE PETITION 13

I. The Kentucky Supreme Court's Decision Conflicts with *Fabe* and Expands the McCarran-Ferguson Act Far Beyond the Limits this Court Has Carefully Calibrated 16

A. The Kentucky Supreme Court's Focus on the Liquidation Law as a Whole Conflicts with *Fabe*'s Focus on the Application of the Particular Sections at Issue 16

B. The Kentucky Supreme Court's Holding that the McCarran-Ferguson Act Reaches Arbitration of Claims Between an Insolvent Insurer and a Third-Party Conflicts with *Fabe*'s Holding that It Does Not Reach Such Third-Party Claims 18

C. The Kentucky Supreme Court's Conflict with *Fabe* Runs Deeper Still 23

II. The Kentucky Supreme Court's Holding Is Sharply at Odds with the Sixth Circuit's, Reflecting a Divide Among the Circuit Courts of Appeals 26

III. This Is an Excellent Vehicle for Resolving an Important Question Regarding the Interplay between the McCarran-Ferguson Act and the FAA 34

CONCLUSION 37

APPENDIX

TABLE OF APPENDICES i

Appendix A

Opinion of the Supreme Court of Kentucky, dated August 26, 2010 ..... App-1

Appendix B

Order Granting Transfer & Consolidation, Supreme Court of Kentucky, dated April 24, 2008 ..... App-27

Appendix C

Opinion and Order Denying Motion to Compel Arbitration, Franklin Circuit Court Second Division, dated September 13, 2007 ..... App-29

Appendix D

U.S. Const, Art. VI, cl. 2 ..... App-41

Relevant Provisions of Ky. Rev. Stat. Ann. App-42

Ky. Rev. Stat. Ann. § 304.33-010 ..... App-42

Ky. Rev. Stat. Ann. § 304.33-030 ..... App-45

Ky. Rev. Stat. Ann. § 304.33-040 ..... App-50

Ky. Rev. Stat. Ann. § 304.33-140 ..... App-56

Ky. Rev. Stat. Ann. § 304.33.160..... App-61

Appendix E

Affidavit of David S. Meyer, dated April 18, 2005, attaching Engagement Letter containing mandatory arbitration clause, dated July 22, 2002 ..... App-63

TABLE OF AUTHORITIES

Cases

Allied-Bruce Terminix Cos. v. Dobson,
513 U.S. 265 (1995) 7, 34

Am. Bankers Ins. Co. v. Inman,
436 F.3d 490 (5th Cir. 2006) 22

AmSouth Bank v. Dale,
386 F.3d 763 (6th Cir. 2004) ..... passim

Assoc. Indus. of Ky., Inc. v. U.S. Liability Ins. Group,
531 F.3d 462 (6th Cir. 2008) 5

Bily v. Arthur Young & Co.,
834 P.2d 745 (Cal. 1992) 36

Davister Corp. v. United Republic Life Ins. Co.,
152 F.3d 1277 (10th Cir. 1998) 15, 29, 30, 32

Dean Witter Reynolds, Inc. v. Byrd,
470 U.S. 213 (1985) 35

Dep't of Treasury v. Fabe,
508 U.S. 491 (1993) ..... passim

Garcia v. Island Program Designer, Inc.,
4 F.3d 57 (1st Cir. 1993) 33

Gross v. Weingarten,
217 F.3d 208 (4th Cir. 2000) 32, 33

Group Life & Health Ins. Co. v. Royal Drug,
440 U.S. 205 (1979) 21, 23, 24, 25

Humana, Inc. v. Forsyth,
525 U.S. 299 (1999) 8, 26

Mastrobuono v. Shearson Lehman Hutton, Inc.,
514 U.S. 52 (1995) 34

Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S . 1 (1983) 35

Munich Am. Reins. Co. v. Crawford, 141 F.3d 585 (5th Cir. 1998) 30, 31, 32

Nw. Corp. v. Nat'l Union Fire Ins. Co., 321 B.R. 120 (D. Del. 2005) 30

Preston v. Ferrer, 552 U.S. 346 (2008) 6, 7

Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974) 34

SEC v. Nat'l Securities, Inc., 393 U.S. 453 (1969) 9, 18, 23, 25

SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) 24

Shalala v. Guernsey Mem'l Hosp., 514 U.S. 87 (1995) 36

Shearson/Am. Express Inc. v. McMahon, 482 U.S. 220 (1987) 7, 22, 26, 35

Southland Corp. v. Keating, 465 U.S. 1 (1984) 1

Stephens v. Am. Int'l Ins. Co., 66 F.3d 41 (2d Cir. 1995) 31, 32

Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119 (1982) ..... passim

Statutes

9 U.S.C. § 2 ..... passim

15 U.S.C. § 1012(b) ..... passim

15 U.S.C. § 1015 38

28 U.S.C. § 1257(a) 1

28 U.S.C. § 1331 32

31 U.S.C. § 3713 22

State Statutes

1996 Ky. Acts ch. 183, § 1 31

Ky. Rev. Stat. Ann. § 304.33-010 ..... passim

Ky. Rev. Stat. Ann. § 304.33-040 ..... passim

Ky. Rev. Stat. Ann. § 304.33-140 6

Ky. Rev. Stat. Ann. § 304.33-150 6

Ohio Rev. Code Ann.
§ 3903.02 (Anderson 1989) 17

Ohio Rev. Code Ann.
§ 3903.42 (Anderson 1989) 17, 19

OPINIONS BELOW

The opinion of the Supreme Court of Kentucky is reported at ___ S.W.3d ___, 2010 WL 3374414, and is reproduced in the appendix at App. 1.

The unpublished order of the Kentucky Supreme Court transferring the case from the Kentucky Court of Appeals is reproduced at App. 27.

The unpublished opinion and order of the Franklin Circuit Court, which was affirmed by the Kentucky Supreme Court, is reproduced at App. 29.

JURISDICTION

The Kentucky Supreme Court rendered its decision on August 26, 2010, affirming the denial of Petitioners' motion to compel arbitration. This petition for certiorari was filed within 90 days, on November 22, 2010. This Court has jurisdiction under 28 U.S.C. § 1257(a). *Southland Corp. v. Keating*, 465 U.S. 1, 6–8 (1984).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Section 2(b) of the McCarran-Ferguson Act, 15 U.S.C. § 1012(b), provides in pertinent part:

> No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance.

Section 2 of the Federal Arbitration Act, 9 U.S.C. § 2, provides in pertinent part:

> A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

Ky. Rev. Stat. Ann. § 304.33-010(6) provides:

> If there is a delinquency proceeding under this subtitle, the provisions of this subtitle shall govern those proceedings, and all conflicting contractual provisions contained in any contract between the insurer which is subject to the delinquency proceeding and any third party shall be deemed subordinated to the provisions of this subtitle.

Ky. Rev. Stat. Ann. § 304.33-040(3)(a) provides:

> The court shall have exclusive jurisdiction to entertain, hear, or determine all matters in any way relating to any delinquency proceeding under this subtitle, including, but not limited to, all disputes involving purported assets of the insurer.

U.S. Const., Art. VI, cl. 2, is reproduced in the Appendix at App. 41. Ky. Rev. Stat. Ann. §§ 304.033-010, -030, -040, -140, and -160 are reproduced in full starting at App. 42.

STATEMENT OF THE CASE

This case involves an effort by the Kentucky Supreme Court to protect the State's anti-arbitration policies from federal preemption by giving an extraordinarily broad construction to the McCarran-Ferguson Act, 15 U.S.C. § 1012(b). That Act protects state laws that are enacted "for the purpose of regulating the business of insurance" from being "invalidate[d], impair[ed], or supersede[d]" by general federal laws, such as the Federal Arbitration Act ("FAA"), 9 U.S.C. § 2. The decision below extends the McCarran-Ferguson Act far beyond the limits carefully imposed by this Court and vitiates the critical federal policy underlying the FAA in the context of an ordinary tort suit far removed from the business of insurance.

The decision below read an exclusive-jurisdiction provision to reflect an anti-arbitration policy, and then it construed the McCarran-Ferguson Act to allow Kentucky to prohibit arbitration of a garden-variety tort suit brought on behalf of an insolvent insurer against its former auditor. The question of whether that dispute should be arbitrated has virtually nothing to do with the "business of insurance" — indeed, the underlying dispute itself has no apparent connection to the core "business of insurance," *i.e.*, spreading of risk from insured to insurer. Kentucky's anti-arbitration policy is not limited to disputes between policyholders and the insurer, or even between an insurer and a reinsurer. Instead, the Kentucky Supreme Court extended that policy to "all matters in any way relating to any [insurer] delinquency proceedings," including arbitration of disputes like this between an insurer and third-party

auditors or suppliers sounding in ordinary tort and contract principles. Ky. Rev. Stat. Ann. § 304.33-040(3)(a). Notwithstanding this "extremely broad" anti-arbitration rule and the lack of any meaningful connection between it and policyholders, the Kentucky Supreme Court held that the McCarran-Ferguson Act applied and reverse preempted the FAA as to arbitration of this dispute over alleged auditing negligence. App. 14, 19–20.

That decision cannot be reconciled with this Court's precedents, especially *Department of Treasury v. Fabe*, 508 U.S. 491 (1993). The Kentucky Supreme Court's conclusion is also contrary to that of the United States Court of Appeals for the Sixth Circuit, when faced with a similar fact pattern, reflecting deeper tension among the Courts of Appeals as to the scope of protection for forum-preference provisions in similar state liquidation laws. To cabin the McCarran-Ferguson Act to its proper bounds, to reaffirm this Court's precedents, to vindicate the important policies of the FAA, and to clarify this confusion among the lower courts, this Court should grant review.

A. Factual Background

1. Petitioner Ernst & Young LLP ("Ernst & Young") is a firm that provides accounting, auditing, and other services. Petitioner David S. Meyer is an Ernst & Young partner. Respondent, the Commissioner for the Kentucky Department of Insurance, was appointed pursuant to Kentucky's Insurers Rehabilitation and Liquidation Law ("Liquidation Law" or "IRLL"), Ky. Rev. Stat. Ann. § 304.33-010 et seq., as Rehabilitator for AIK Comp

("AIK"). App. 3, 6. AIK is a Kentucky workers' compensation self-insured group. *Id.* Under Kentucky law, workers' compensation through a self-insurance group is similar to ordinary workers' compensation insurance, except that if the group is unable to meet its obligations, the participants are jointly and severally liable for the shortfall. *Assoc. Indus. of Ky., Inc. v. U.S. Liability Ins. Group*, 531 F.3d 462, 464 (6th Cir. 2008).

From 1999 through 2003, Ernst & Young entered into a series of contracts with AIK for auditing and accounting services. App. 4. Each of those contracts includes a mandatory arbitration clause. Although the agreements varied over time, the pertinent portion remained unchanged: "Any controversy or claim arising out of or relating to" Ernst & Young's services "shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding arbitration. . . ." App. 4–5. The parties also agreed that arbitration would be governed by the FAA. *Id.*

Ernst & Young audited AIK's financial statements annually until 2002. App. 5. Each of Ernst & Young's audits indicated that AIK's assets exceeded its liabilities. App 6. In 2003, Ernst & Young resigned as AIK's auditor. App. 5–6.

2. In April 2004, the Kentucky Office of Workers' Claims initiated a financial examination of AIK. App. 6; Ernst & Young Br. 3. That examination revealed that AIK was unable to pay insurance claims because it faced a deficit. App. 6. That deficit grew to approximately $90 million. *Id.* AIK was placed in "rehabilitation" and a "Rehabilitator" was appointed.

Id.; *see* Ky. Rev. Stat. Ann. §§ 304.33-040, -140, -150. The Rehabilitator has required AIK members to pay assessments to cover most of the shortfall. App. 6–7.

The Rehabilitator sued Ernst & Young in Kentucky's Franklin Circuit Court, raising various tort theories of liability. App. 7. The Rehabilitator's claims are brought "on behalf of [AIK]" and are entirely derivative of "causes of action that [AIK] could have maintained in its own name." Compl. ¶¶ 11–12. The Rehabilitator alleges that Ernst & Young negligently audited AIK's financial statements in that those statements materially underestimated the losses AIK would incur due to future claims and, as a result, AIK charged its members premiums that were too low. Compl. ¶¶ 23–25, 42–45. The Rehabilitator sought as damages rehabilitation costs it allegedly would have avoided if it had rehabilitated AIK sooner rather than later. *Id.* ¶ 31. The Rehabilitator sought to resist Ernst & Young's effort to compel arbitration on the basis of a Kentucky law giving a Kentucky court exclusive jurisdiction over "matters relating to any delinquency proceeding." App. 12–13. The threshold question thus arose whether the arbitration clauses in Ernst & Young's contracts are enforceable in the Rehabilitator's tort suit.

B. Statutory Framework

1. The FAA establishes a "national policy favoring arbitration when the parties contract for that mode of dispute resolution." *Preston v. Ferrer*, 552 U.S. 346, 349 (2008). "The FAA's displacement of conflicting state law is 'now well-established'" and has been "repeatedly reaffirmed." *Id.* at 353 (quoting *Allied-*

Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 272 (1995)).

2. Two provisions of Kentucky's Liquidation Law have been construed to prohibit arbitration broadly when an insurer becomes insolvent and enters delinquency proceedings. Section 304.33-040(3)(a) ("Section 40") grants Kentucky courts "exclusive jurisdiction" over "all matters in any way relating to any delinquency proceeding." And § 304.33-010(6) ("Section 10") provides that, if there is a delinquency proceeding, "all conflicting contractual provisions contained in any contract between the insurer . . . and any third party shall be deemed subordinated" to the Liquidation Law.

Ordinarily, an arbitration clause does not conflict with a grant of exclusive jurisdiction because arbitration does not forgo "substantive rights afforded by [a] statute; it only submits to their resolution in an arbitral, rather than a judicial forum." *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 229–30 (1987) (quotation marks omitted). If there is nonetheless a conflict because a state law granting exclusive jurisdiction is construed to prohibit arbitration, however, ordinary preemption principles would require arbitration pursuant to the FAA. App. 10–11; *see Preston*, 552 U.S. at 353. The single, dispositive question here is whether the McCarran-Ferguson Act requires a different result.

3. The McCarran-Ferguson Act provides that, unless a federal law "specifically relates to the business of insurance," it shall not be construed to "invalidate, impair, or supersede" any state law "enacted . . . for the purpose of regulating the business

of insurance." 15 U.S.C. § 1012(b). Accordingly, "when Congress enacts a law specifically relating to the business of insurance, that law controls." *Humana, Inc. v. Forsyth*, 525 U.S. 299, 306 (1999). But when Congress enacts legislation that is "general in character," that law "shall not be 'construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance.'" *Id.* at 306–07. There is no dispute that the FAA is such a general law. When the McCarran-Ferguson Act blocks the preemptive impact of a general federal law, such as the FAA, it is known as "reverse preemption." *E.g.*, *AmSouth Bank v. Dale*, 386 F.3d 763, 782 (6th Cir. 2004).

A state law falls within the scope of the McCarran-Ferguson Act's protection if it "possess[es] the end, intention, or aim of adjusting, managing, or controlling" the "business of insurance." *Fabe*, 508 U.S. at 505 (quotation marks omitted). The Act's protections are not absolute, however. "When federal law does not directly conflict with state regulation, and when application of the federal law would not frustrate any declared state policy or interfere with a State's administrative regime, the McCarran-Ferguson Act does not preclude its application." *Humana*, 525 U.S. at 310.

The Court has made clear that a state law is not considered as a whole when assessing whether it "regulat[es] the business of insurance" or is frustrated by a general federal policy. Instead, the question is whether the application of a particular section or subsection of the law triggers reverse preemption. In *Fabe*, for example, the Court concluded that a state statute setting creditor priority in insurer liquidation

proceedings had reverse-preemptive effect to the extent it gave priorities to policyholders, but not to the extent it gave priority to ordinary third-party creditors. *Fabe*, 508 U.S. at 493–94.

The Court has also emphasized that the focus of the Act is on "the relationship between the insurance company and the policyholder" — and at its core lies the transfer of risk from insured to insurer. *Id.* at 501 (quoting *SEC v. Nat'l Securities, Inc.*, 393 U.S. 453, 460 (1969)). This Court has used three factors to determine whether a practice falls within the "business of insurance": whether it (1) "has the effect of transferring or spreading a policyholder's risk"; (2) "is an integral part of the policy relationship between the insurer and the insured"; and (3) "is limited to entities within the insurance industry." *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 129 (1982). Conversely, a state law is *not* protected from preemption by a general federal law if the state law does not "possess the 'end, intention, or aim' of adjusting, managing, or controlling" (1) the transfer of risk; (2) another "integral part of the policy relationship between the insurer and the insured"; or (3) a practice that is limited to the insurance industry. *Fabe*, 508 U.S. at 505; *Pireno*, 458 U.S. at 129.

C. Procedural History

1. On March 25, 2005, the Rehabilitator sued Ernst & Young in Franklin Circuit Court. Members of AIK that paid assessments to cover AIK's shortfalls subsequently brought a class action against Ernst & Young. App. 7.

Ernst & Young moved to compel arbitration in both suits, arguing that the FAA mandated their

enforcement and that the McCarran-Ferguson Act did not reverse preempt the FAA. *Id.* As Ernst & Young's counsel put it, "McCarran-Ferguson does not keep . . . the FAA from applying" because "a garden variety, run-of-the-mill claim against Ernst & Young has nothing to do with the regulation or taxation of the business of insurance." Hearing Tr. at 50, Franklin Cir. Ct. (Aug. 28, 2007).

The Franklin Circuit Court denied the motions to compel in both cases. App. 7. Among other reasons for denying the motion in the Rehabilitator's suit, the court held that the McCarran-Ferguson Act reverse preempted the FAA. App. 38–39.

2. Ernst & Young appealed in both cases, and the appeals were transferred to the Kentucky Supreme Court. App. 7. In the Rehabilitator's case, Ernst & Young claimed that the FAA mandated arbitration and argued that the state rehabilitation court's "finding of reverse-preemption under the McCarran-Ferguson Act was erroneous." Ernst & Young Br. 14; *see also id.* at 8. Ernst & Young's briefing on the McCarran-Ferguson Act primarily argued that arbitration of an ordinary tort dispute arising out of the auditing contract would not "invalidate, impair, or supersede" Sections 10 and 40 of Kentucky's Liquidation Law, which grant the state court exclusive jurisdiction over delinquency proceedings and trump contrary contractual provisions. *Id.* at 8, 15–16. In response, the Rehabilitator argued that the Kentucky Liquidation Law (1) regulated the business of insurance; and (2) would be "impair[ed]" by the FAA. Rehabilitator Br. 9–12, 12–25. At oral argument, Ernst & Young emphasized that any Kentucky rule barring arbitration of the auditing

dispute here would not be aimed at "regulating the business of insurance." § 1012(b). In particular, Ernst & Young argued that it was contrary to *Fabe* for the trial court to hold that the McCarran-Ferguson Act encompasses a restriction on arbitrating tort claims brought by a rehabilitator against a former auditor. *See* Rehabilitator Opp. to Motion for Stay 5 n.2 (noting "E&Y's counsel's reference at oral argument" to *Fabe*).

3. On August 26, 2010, the Kentucky Supreme Court affirmed in the Rehabilitator's case. App. 2–3. The Kentucky Supreme Court agreed with Ernst & Young that the lower court had "failed to recognize the supremacy of the Federal Arbitration Act and its establishment of a national policy favoring the arbitration of disputes." App. 9. It also recognized that Ernst & Young's contracts each contained valid arbitration clauses that were generally enforceable under the FAA. App. 4–6, 8–11. But the Kentucky Supreme Court held that, due to the McCarran-Ferguson Act, those arbitration clauses were unenforceable.

First, the Kentucky Supreme Court considered and rejected Ernst & Young's argument that prohibiting arbitration here would not "regulat[e] the business of insurance." The Kentucky Supreme Court held that the Liquidation Law as a whole, "of which [Section 10] is a part, was enacted to regulate the 'business of insurance.'" App. 11. "The [Liquidation Law] is itself the ultimate measure of the state's regulation of the insurance business: the take-over of a failing insurance company." App. 12. The Court did not evaluate, however, the purpose of the particular provisions that were arguably "invalidate[d],

impair[ed], or supersede[d]": Section 40's grant of exclusive jurisdiction to the state court over "all matters in any way relating to any delinquency proceeding," and Section 10's command that conflicting contractual provisions are unenforceable. Ky. Rev. Stat. Ann. §§ 304.33-010(6), 040(3)(a).

Second, the Court held that the FAA conflicted with this sweeping grant of exclusive jurisdiction to the state court. App. 13. "[A]n essential goal of the [Liquidation Law] is to promote consistent rulings in all matters that impact the rehabilitation of an insurance company," the Court explained. App. 15. The "strong grant of exclusive jurisdiction" is designed to avoid "[p]iecemeal adjudication and the potential for inconsistent verdicts." App. 16. Foreclosing arbitration of "all matters in any way relating to any delinquency proceeding" would eliminate the "potential for such inefficiencies." *Id.*; Ky. Rev. Stat. Ann. § 304.33-040(3)(a).

The Kentucky Supreme Court also held that arbitration would not "invalidate, impair, or supersede" the state court's exercise of exclusive jurisdiction. It recognized that a "trial court technically retains jurisdiction over [a] proceeding" during arbitration. App. 18. But "the trial court no longer retains the authority to 'determine all matters in any way related to the delinquency,'" as it must defer to the arbitrators' findings and rulings of law in many circumstances. *Id.* "Such a substantial reduction of the court's role in a process central to the rehabilitation of an insurance company is inconsistent" with the grant of exclusive jurisdiction. App. 19.

The Kentucky Supreme Court's reasoning thus boiled down to a syllogism: (1) Kentucky's Liquidation Law as a whole was enacted to regulate the business of insurance, and the grant of exclusive jurisdiction to the rehabilitation court over "all matters in any way relating to any delinquency proceedings" is part of that law; (2) that grant of exclusive jurisdiction would be "invalidate[d], impair[ed], or supersede[d]" by arbitration; *therefore*, (3) the FAA is reverse preempted as to arbitration of "a[ny] matte[r] in any way relating to any delinquency proceedings." App. 11, 13–14.

In the separate members' class action, the Kentucky Supreme Court reversed, holding that the arbitration clauses *were* enforceable. App. 2–3, 25. The McCarran-Ferguson Act was not at issue in that case. Rather, it focused on whether the class members were bound by the arbitration clause signed by AIK. App. 23–26. Finding that the class members were bound, the Kentucky Supreme Court remanded to compel arbitration. App. 25.

4. On September 15, 2010, Ernst & Young moved for the Kentucky Supreme Court to enter a stay in the Rehabilitator's suit pending a petition for certiorari. On October 15, 2010, the Kentucky Supreme Court denied that motion.

On November 22, 2010, Ernst & Young timely filed this petition for certiorari in the Rehabilitator's suit.

REASONS FOR GRANTING THE PETITION

This Court's review is warranted for two primary reasons. *First*, the Kentucky Supreme Court's

expansive interpretation of the McCarran-Ferguson Act is contrary to this Court's careful construction of that Act in *Fabe*. The decision below conflicts with *Fabe* in two important respects. First, by considering whether the Liquidation Law as a whole was enacted to regulate the "business of insurance," the Kentucky Supreme Court ignored this Court's clear direction in *Fabe* to consider specifically the application of the particular sections that face preemption — here, applying Kentucky's exclusive jurisdiction provisions to preclude the arbitration of disputes with third-parties having nothing to do with the insured-insurer relationship. Second, the Kentucky Supreme Court's methodological error in turn led it to a holding that cannot be reconciled with *Fabe*'s bottom line.

All nine Justices in *Fabe* agreed that the McCarran-Ferguson Act did not save the claims of ordinary creditors from being subordinated to federal claims under the federal priority statute. *Fabe*, 508 U.S. at 509 (majority op.); *id.* at 517 (Kennedy, J., dissenting). The arbitral dispute below is similarly removed from the "business of insurance" and the insured-insurer relationship. The Rehabilitator is simply seeking money damages from a third party, trying to make Ernst & Young a debtor. Indeed, if Ernst & Young brought a counterclaim against the Rehabilitator to recover unpaid fees, it would be a creditor — putting it in precisely the same position as the creditors that did not receive the benefit of reverse preemption in *Fabe*. It is immaterial that the Rehabilitator seeks to recover from Ernst & Young, rather than vice versa.

The decision below thus clearly conflicts with *Fabe*. The Kentucky Supreme Court prohibited

arbitration of "all matters in any way relating to any delinquency proceeding." This rule and the Kentucky Supreme Court's application of it here expand the McCarran-Ferguson Act far beyond the limits this Court has established. If left uncorrected, Kentucky and other states will be able to apply anti-arbitration state policies that the FAA was designed to displace — and that the McCarran-Ferguson Act was not designed to save. The McCarran-Ferguson Act is not even remotely as elastic as the Kentucky Supreme Court held.

Second, the Kentucky Supreme Court's opinion conflicts with the Sixth Circuit's decision in *AmSouth Bank v. Dale*, 386 F.3d 763 (6th Cir. 2004), which in turn conflicts with the Tenth Circuit's decision in *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277, 1281 (10th Cir. 1998). In *AmSouth*, the Sixth Circuit held that the McCarran-Ferguson Act does *not* protect a state law prohibiting another forum from adjudicating "an ordinary suit against a tortfeasor by an insolvent insurance company." 386 F.3d at 783. While the forum-selection issue in *AmSouth* involved the choice between federal court and state court, rather than between arbitration and state court, courts have treated those issues interchangeably and the conflict is stark. Had the Kentucky Supreme Court applied the rule of law applied in *AmSouth*, it would have reversed, not affirmed, the judgment below.

The issues at stake here are also important. This Court has repeatedly considered cases to ensure that the important policies of the FAA are not frustrated by state courts hostile to arbitration. The benefits of arbitration are particularly important to accountants,

given the complexity and nuance of accounting and the temptation to sue the auditor, using 20/20 hindsight, when the audit client faces financial difficulty. To vindicate both this Court's decision in *Fabe* and the policies of the FAA, and to resolve this conflict among the lower courts, this Court should grant review.

I. THE KENTUCKY SUPREME COURT'S DECISION CONFLICTS WITH *FABE* AND EXPANDS THE MCCARRAN-FERGUSON ACT FAR BEYOND THE LIMITS THIS COURT HAS CAREFULLY CALIBRATED

A. The Kentucky Supreme Court's Focus on the Liquidation Law as a Whole Conflicts with *Fabe*'s Focus on the Application of the Particular Sections at Issue

The Kentucky Supreme Court erred off the bat in its analysis of whether the FAA was reverse preempted. In assessing whether McCarran-Ferguson protection applied here, the Kentucky Supreme Court focused on the purpose of the Liquidation Law as a whole — rather than the specific provisions of that law which would be "invalidate[d], impair[ed], or supersede[d]" by the FAA. § 1012(b). The Court explained, "the IRLL, of which [Section 10] is a part, was enacted to regulate the 'business of insurance.'" App. 11. The Liquidation Law "is itself the ultimate measure of the state's regulation of the insurance business: the take-over of a failing insurance company." App. 12.

Fabe forecloses this approach. As here, *Fabe* assessed a provision that was part of a state's insurer liquidation law. *See* Ohio Rev. Code Ann. §§ 3903.02,

3903.42 (Anderson 1989). If location in the state insurance code was the "ultimate measure," *Fabe* could have been a very short opinion. It was not.

Rather than focusing on the purpose of that law as a whole — as the Kentucky Supreme Court did below — the Court in *Fabe* trained its focus on the specific section of that law that would be "invalidate[d], impair[ed], or supersede[d]." § 1012(b). Indeed, the *Fabe* majority focused even more narrowly on the purpose underlying the *different subsections* that faced possible preemption, and that narrow focus was reflected in the Court's holding. *Fabe* held that subsection (C), which granted priority to claims by policyholders, was enacted "for the purpose of regulating the business of insurance" — but subsection (E), which granted priority to general, third-party creditors over claims of the federal government, was not. *Fabe*, 508 U.S. at 493–94, 508–09; *see* Ohio Rev. Code Ann. § 3903.42(C), (E).

The Kentucky Supreme Court's analytical error of focusing on the Liquidation Law as a whole, rather than the particular application of the sections at issue, allowed the Kentucky Supreme Court to find that Sections 10 and 40 were entirely protected by the McCarran-Ferguson Act, despite their "extremely broad" reach to "all matters in any way relating to any delinquency proceedin[g]." App. 14; Ky. Rev. Stat. Ann. § 304.33-040(3)(a). This error thereby enabled the Kentucky Supreme Court to hold that its anti-arbitration implementation of the exclusive-jurisdiction provision could be applied to this garden-variety tort dispute between the insurer and a third party — without even considering that arbitrating this third-party tort suit would have, at most, an

extraordinarily attenuated impact on the relationship between policyholders and AIK. *See* App. 9–20. This is clearly contrary to *Fabe*'s command that the impact on the insured-insurer relationship must be "the focus" of the McCarran-Ferguson Act inquiry. 508 U.S. at 501; *see also Nat'l Securities*, 393 U.S. at 460.

B. The Kentucky Supreme Court's Holding that the McCarran-Ferguson Act Reaches Arbitration of Claims Between an Insolvent Insurer and a Third-Party Conflicts with *Fabe*'s Holding that It Does Not Reach Such Third-Party Claims

The Kentucky Supreme Court's methodological error in turn led to a deeper conflict with *Fabe*. At bottom, *Fabe* holds that the McCarran-Ferguson Act protects a provision of a state insurer liquidation law only to the extent it provides direct, targeted benefits to policyholders — and not to the extent it benefits ordinary, third-party creditors of an insolvent insurer. *Fabe*, 508 U.S. at 493–94. The Kentucky Supreme Court obliterated this distinction and held that the McCarran-Ferguson Act reaches arbitration of a dispute between an insolvent insurer and ordinary, third-party debtors. App. 19–20. This is squarely contrary to *Fabe*.

1. At issue in *Fabe* was one section of Ohio's insurer liquidation law, which ranked the priority of different creditors' claims against an insurer in state liquidation proceedings. *Fabe*, 508 U.S. at 493. The law conferred first priority to policyholders over all other creditors, but demoted claims by government entities behind ordinary creditors. Ohio Rev. Code Ann. § 3903.42(C), (E). The federal priority statute,

by contrast, generally confers first priority to United States government claims. 31 U.S.C. § 3713. The question presented was thus whether the McCarran-Ferguson Act reverse preempted the federal priority statute. In *Fabe*, the Supreme Court gave a carefully measured answer: Ohio's ranking of creditor priorities was "enacted for the purpose of regulating the business of insurance," and thus protected from preemption — but only to the extent it gave priority to policyholders specifically. 508 U.S. at 493. The same law was *not* aimed at regulating the business of insurance to the extent it granted priority to other, third-party creditors over the United States. *Id.* at 494.

The *Fabe* majority reasoned that "actual performance of an insurance contract" is part of the "business of insurance." *Id.* at 505. Granting policyholders first priority over the United States gave policyholders a targeted benefit, directly increasing the likelihood that there would be actual performance, *i.e.*, that "policyholders ultimately will receive payment on their [insurance] claims." *Id.* at 506. But granting priority to other creditors did no such thing. "[E]very preference accorded to the creditors of an insolvent insurer ultimately may redound to the benefit of policyholders by enhancing the reliability of the insurance company," the Court recognized. *Id.* at 508. But such "indirect effects" on the policyholder-insurer relationship were "too tenuous" to be protected by the McCarran-Ferguson Act. *Id.* at 509.

2. The Kentucky Supreme Court's holding cannot be reconciled with *Fabe*. The Kentucky Supreme Court reasoned that the Liquidation Law as a whole

was enacted to "regulat[e] the business of insurance," and arbitration would conflict with the rehabilitation court's exclusive jurisdiction over "all matters in any way related to any delinquency proceedings." App. 11, 13; Ky. Rev. Stat. Ann. § 304.33-040(3)(a). And it applied this rule to conclude that the McCarran-Ferguson Act protects its prohibition against arbitrating this garden-variety tort claim against a third party. App. 19.

This result is squarely opposed to *Fabe*, as the relationship between Respondents and Petitioners here is the mirror image of the relationship between the creditors and the insolvent insurer, which *Fabe* held not to be "regulat[ion of] the business of insurance." 508 U.S. at 508–09. Just like *Fabe*, which involved claims between third parties and the insolvent insurer, this case involves claims between third parties and the insolvent insurer (via the rehabilitator). And although the direction of the claims is different -- the third-parties were creditors in *Fabe*, while the Rehabilitator seeks to make Ernst & Young a debtor here — that is a distinction without a difference. Indeed, if Ernst & Young sought to collect unpaid fees from the Rehabilitator — or if Ernst & Young filed a counterclaim in this very tort suit — it would become a creditor Its claims would thus have precisely the same attenuated relationship to policyholders that *Fabe* found to be beyond the scope of McCarran-Ferguson protection.

A creditor/debtor distinction is not only functionally meaningless, but also it is senseless under *Fabe*'s rationale. Whether the third party is a debtor or a creditor, either way a resolution of the third-party claims would only impact policyholders

indirectly, via the insurer's bottom line. And *Fabe* squarely establishes that such an impact on an insurer's balance sheet is not enough to trigger McCarran-Ferguson Act protection. "'[E]very business decision made by an insurance company has some impact on its reliability . . . and its status as a reliable insurer.'" *Fabe*, 508 U.S. at 508 (quoting *Group Life & Health Ins. Co. v. Royal Drug*, 440 U.S. 205, 216–17 (1979)). But such "indirect effects" on the insured-insurer relationship via an improvement to the insurer's balance sheet are insufficient to trigger reverse preemption. *Id.* at 509; *see also Royal Drug*, 440 U.S. at 214, 216–17. Accordingly, the Kentucky Supreme Court's conclusion that the McCarran-Ferguson Act reaches such third-party claims is contrary to *Fabe*.

Indeed, the question of *whether to arbitrate* an ordinary tort suit between an insolvent insurer and a third party has even less to do with "regulating the business of insurance" than the third-party creditor preferences that *Fabe* held were beyond the McCarran-Ferguson Act's reach. *Fabe*, 508 U.S. at 493–94. Ohio's statute ranked the order of various creditors of an insolvent insurer, establishing a substantive rule that plausibly could impact the creditworthiness of that insurer, albeit "indirect[ly]." *Id.* at 508–09. By contrast, this is a tort suit about auditing, a topic far afield from the insured-insurer relationship. Furthermore, prohibiting arbitration of this dispute "does not entail any consequential restriction on substantive rights". *McMahon*, 482 U.S. at 232. It merely regulates whether the dispute will be resolved "in an arbitral, rather than judicial forum." *McMahon*, 482 U.S. at 229–30 (quotation marks omitted).

To be sure, to the extent Kentucky wanted to apply its anti-arbitration policies to coverage disputes between policyholders and the insurer, it could do so under *Fabe*: that rule would govern the insured-insurer relationship. *E.g., Am. Bankers Ins. Co. v. Inman*, 436 F.3d 490, 494 (5th Cir. 2006). But it is just as clear under *Fabe* that Kentucky cannot extend its anti-arbitration policies to claims between a rehabilitator and ordinary third parties, like Petitioners. It simply does not matter to a policyholder's relationship with its insurer whether, if the insurer becomes insolvent, enters state liquidation proceedings, and the Rehabilitator sues a third party in tort, that suit will be heard by an arbitrator or a state court judge.

3. The Kentucky Supreme Court's decision would fare even worse under the *Fabe* dissent. Justice Kennedy, joined in dissent by Justices Scalia, Souter, and Thomas, advocated a narrower reading of the McCarran-Ferguson Act. In their view, Ohio's entire priority statute was unprotected, as it was "too removed from the contractual relationship between the policyholder and the insurance company." *Fabe*, 508 U.S. at 517 (Kennedy, J., dissenting). "This is not the regulation of the business of insurance, but the regulation of creditors' rights in an insolvency proceeding." *Id.* at 513. Under the dissent's reasoning, the entire subject of insurer liquidation would be too far removed from the business of insurance.

All nine Justices in *Fabe* agreed, however, that not every provision a state includes in an insurer liquidation law is enacted to "regulat[e] the business of insurance." Rather, provisions in state insurer

liquidation laws that merely have a generalized impact on the reliability of an insurer are "too tenuous" and "too removed" from regulation of the core business of insurance to be protected by the McCarran-Ferguson Act. *Id.* at 509 (majority op.); *id.* at 517 (Kennedy, J., dissenting).

This Court's earlier decisions also consistently warn against reading the McCarran-Ferguson Act so broadly that it protects laws or practices that have only a generalized impact on the insurer's balance sheet. *See, e.g., Nat'l Securities*, 393 U.S. at 460; *Pireno*, 448 U.S. at 132. For example, in *Royal Drug*, this Court held that an insurer's "arrangements for the purchase of goods and services" are not part of the "business of insurance." *Royal Drug*, 440 U.S. at 214. So long as the insurer provided the coverage it promised, policyholders were "basically unconcerned" with the insurer's behind-the-scenes arrangements with third parties for goods or services. *Id.* Although those contracts "may well be sound business practice, and may well inure ultimately to the benefit of policyholders in the form of lower premiums," these indirect impacts were insufficient to be shielded by the McCarran-Ferguson Act. *Id.*

C. The Kentucky Supreme Court's Conflict with *Fabe* Runs Deeper Still

1. The Kentucky Supreme Court's holding also fails when viewed in light of the three-factor *Fabe/Pireno* test. Kentucky's refusal to permit arbitration of the dispute between the Rehabilitator and Ernst & Young does not "regulat[e] the business of insurance" because it does not "possess the 'end, intention, or aim' of adjusting, managing, or

controlling" (1) the transfer of risk; (2) another "integral part of the policy relationship between the insurer and the insured"; or (3) a practice that is limited to the insurance industry. *Fabe*, 508 U.S. at 505; *Pireno*, 458 U.S. at 129.

First, foreclosing arbitration of an insolvent insurer's suit against a former auditor is not even arguably aimed at "transferring or spreading a policyholder's risk" from the insured to the insurer. *Pireno*, 458 U.S. at 129. The underlying tort dispute over auditing has nothing to do with the transfer of risk — and the question whether to arbitrate that dispute is even further removed from the "true underwriting of risks, the one earmark of insurance." *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 73 (1959).

Second, the choice of forum for hearing a tort suit between a rehabilitator and an auditor is surely not an "integral part of the policy relationship between the insurer and the insured." *Pireno*, 458 U.S. at 129. Indeed, *Royal Drug* established that "arrangements for the purchase of goods and services" are not part of the "business of insurance" at all. *Royal Drug*, 440 U.S. at 214. Although the contractual relationship between an insurer and third party providers of goods or services "may well inure ultimately to the benefit of policyholders in the form of lower premiums," the policyholder is "basically unconcerned" about such matters. *Id.* Policyholders have even less concern for whether a tort suit arising from an insurer's business relationship with a third party will be arbitrated. The policyholder's concern "is *whether* his claim is paid, not *why* it is paid" — much less how the insurer's assets and liabilities are accounted for and whether

lawsuits arising from that accounting are heard by an arbitrator. *Pireno*, 448 U.S. at 132; *see also Nat'l Securities*, 393 U.S. at 460.

Third, the refusal to permit arbitration here is obviously not "limited to entities within the insurance industry." *Pireno*, 458 U.S. at 132. It involves "third parties wholly outside the insurance industry" — namely, Ernst & Young. *Id.*

A rule barring arbitration of this ordinary tort suit between a rehabilitator and a third party thus does not remotely constitute a law that "possess[es] the 'end, intention, or aim' of adjusting, managing, or controlling" the "business of insurance." *Fabe*, 508 U.S. at 505. "Insurance companies may do many things which are subject to paramount federal regulation; only when they are engaged in the 'business of insurance' does the statute apply." *Nat'l Securities*, 393 U.S. at 459–60. After all, the statute "exempts the 'business of insurance' and not the 'business of insurance companies.'" *Royal Drug*, 440 U.S. at 217. Arbitration of this tort suit falls in the latter category, and thus Kentucky's anti-arbitration rule here is not protected by the McCarran-Ferguson Act.

2. The Kentucky Supreme Court's same misreading of the Act can also be seen as an overly broad interpretation of the statutory phrase "invalidate, impair, or supersede." § 1012(b). Arbitration clauses are generally enforceable, irrespective of a court's exclusive jurisdiction, because arbitration does not alter "substantive rights," the scope of the relief available, or eliminate court review of the arbitral award; it merely regulates the choice of

initial forum. *McMahon*, 482 U.S. at 229–30. Of course, the Kentucky Supreme Court is free, as a matter of Kentucky law, to read Section 40's grant of exclusive jurisdiction to state courts as prohibiting arbitration of "all matters in any way related to any delinquency proceedings." Ky. Rev. Stat. Ann. § 304.33-040(3)(a). But the meaning of "invalidate, impair, or supersede" is a question of federal law. *See Humana*, 525 U.S. at 307–10. By interpreting Kentucky's exclusive jurisdiction provision as an anti-arbitration rule that reaches matters so far removed from core rehabilitation proceedings, the Kentucky Supreme Court ensured that "any 'impairment'" of such proceedings by allowing arbitration would be "most indirect." *Humana*, 525 U.S. at 311 (quoting *Nat'l Securities*, 393 U.S. at 463). That is insufficient.

In short, the Kentucky Supreme Court applied a test that *Fabe* rejected to reach a result that *Fabe* foreclosed: that the McCarran-Ferguson Act protects a state-law ban against arbitrating "all matters in any way relating to any delinquency proceedings," including an ordinary tort suit between an insolvent insurer and a third party. *Fabe* establishes that the Act is nowhere near that broad. The Kentucky Supreme Court's decision therefore merits this Court's review.

II. THE KENTUCKY SUPREME COURT'S HOLDING IS SHARPLY AT ODDS WITH THE SIXTH CIRCUIT'S, REFLECTING A DIVIDE AMONG THE CIRCUIT COURTS OF APPEALS

1. The Kentucky Supreme Court's interpretation of the McCarran-Ferguson Act also conflicts with the

Sixth Circuit's. In *AmSouth Bank v. Dale*, 386 F.3d 763 (2004), as here, an insurer was in delinquency proceedings under a state liquidation law, which broadly prohibited any suit against the insurer in any forum other than the state court — indeed, in *AmSouth*, a state court entered an anti-suit injunction expressly prohibiting any such suit. *Id.* at 780. And as here, a dispute arose between the state rehabilitator and a third party who had provided professional services to the insurer — here, an auditor, there, banks. After the rehabilitator threatened to sue them in tort, the banks sought a declaratory judgment in federal court that there was no tort liability. *Id.* at 770–72. The rehabilitator invoked the McCarran-Ferguson Act, arguing that the state liquidation law's exclusive jurisdiction provision, backed by the anti-suit injunction, reverse-preempted the federal courts from exercising their diversity jurisdiction over the dispute. *Id.* at 780–81.

The Sixth Circuit disagreed. "[A]n ordinary suit against a tortfeasor by an insolvent insurance company implicates a 'regulation of the business of insurance' only in the attenuated fashion rejected in *Fabe*." *Id.* at 783. The injunction against litigation in any forum other than the state court "would only be a regulation of the business of insurance to the extent it protected the assets of the insurance company from suit." *Id.* Furthermore, there was no "impairment," within the meaning of the McCarran-Ferguson Act, because "the integrity of the core liquidation proceedings [was not] attacked." *Id.*

On parallel facts here, the Kentucky Supreme Court reached the opposite result. To the Kentucky Supreme Court, "an ordinary suit against a tortfeasor

by an insolvent insurance company" *does* involve "regulation of the business of insurance." App. 11. And adjudication by another forum *does* constitute an "impairment," within the meaning of the McCarran-Ferguson Act, because arbitration would conflict with an "an essential goal" of the delinquency proceedings. App. 13–15.

Although this suit involves arbitral jurisdiction under 9 U.S.C. § 2, while *AmSouth* involves federal court jurisdiction under 28 U.S.C. § 1331, nothing in either decision suggests that this distinction is material. To the contrary, *AmSouth* treats arbitration-versus-state-court cases and federal-versus-state-court cases as fungible precedents addressing whether the McCarran-Ferguson Act saves from preemption a state law's preference for an exclusive state-court forum. *See AmSouth*, 386 F.3d at 781–82. The distinction is also immaterial under the exclusive-jurisdiction provisions here and in *AmSouth*: Both require that state courts — and only state courts — adjudicate the tort suit against the third party. Here and in *AmSouth*, the third party nonetheless invoked a general federal law to transfer the suit to another forum. The Kentucky Supreme Court held that the McCarran-Ferguson Act stood as a bar to this effort. The Sixth Circuit held that it did not.

2. Contrary to *Fabe* and *AmSouth*, the Tenth Circuit joins the Kentucky Supreme Court in holding that the McCarran-Ferguson Act protects state law provisions barring other forums from hearing an ordinary tort suit between an insolvent insurer and a third party. *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277, 1281 (10th Cir. 1998). In

Davister, as here, the underlying dispute had nothing to do with the transfer of risk nor was it an "integral part" of the policyholder-insurer relationship — it arose from a real estate deal — and it involved an entity wholly outside the insurance industry — a realty company. *Id.* at 1278. And as here, the question *whether to arbitrate* that dispute was even further removed from the "business of insurance." Nonetheless, the Tenth Circuit found reverse preemption. *Id.* at 1281. The court reasoned that arbitration would "impair the progress of the orderly resolution of all matters involving the insolvent company" and a win in litigation would improve the insurer's bottom line. *Id.* The Court admitted that these benefits would inure equally "to other creditors," but it found that this did not "dimins[h] or denigrat[e]" its conclusion that the law regulated the business of insurance. *Id.*

Judge Lucero dissented, pointing to *Fabe*'s holding that the McCarran-Ferguson Act does not protect state liquidation laws to the extent they merely provide generalized, indirect benefits to policyholders. *Id.* at 1282. Judge Lucero warned that "[t]o bring this dispute within the reach of McCarran-Ferguson reverse pre-emption would swallow the very fine distinction set forth by *Fabe*'s majority, potentially precluding federal jurisdiction over any dispute involving an insolvent insurance company." *Id.* at 1283. The Tenth Circuit majority did not heed this warning and neither did the Kentucky Supreme Court.

3. The conflict between this case and *Davister*, on one hand, and *AmSouth* on the other, marks the latest — and sharpest — divide between two

divergent lines of opinion among the Courts of Appeals as to the scope of the McCarran-Ferguson Act's protection for state liquidation laws that restrict litigants' access to other forums. This divide has been noted repeatedly. *E.g.*, *AmSouth*, 386 F.3d at 782 (describing two "different line[s] of cases"); *Nw. Corp. v. Nat'l Union Fire Ins. Co.*, 321 B.R. 120, 125–26 (D. Del. 2005) ("the case law runs both ways").

The leading case for an expansive reading of the McCarran-Ferguson Act is *Munich American Reinsurance Co. v. Crawford*, 141 F.3d 585 (5th Cir. 1998). *See Davister*, 152 F.3d at 1280–82 (following *Munich*); *AmSouth*, 386 F.3d at 783 (rejecting *Munich*). In *Munich*, the Fifth Circuit held that Oklahoma's insurer liquidation law "reverse preempted" arbitration of a suit in which an insolvent insurer sued a reinsurer for damages. *Munich*, 141 F.3d at 590. Like the Kentucky Supreme Court, the Fifth Circuit concluded that Oklahoma's "comprehensive regulatory scheme, viewed in its entirety," was aimed at regulating the business of insurance. *Id.* at 592. And like the Kentucky Supreme Court, the Fifth Circuit interpreted "impair" broadly, concluding that Oklahoma law barred arbitration, without examining the relationship between the choice of forum and the "business of insurance." *Id.* at 594–95.

The result in *Munich* is less troubling than the decisions below and in *Davister*, however. Unlike this suit and *Davister*, which involve run-of-the-mill tort suits against third parties outside the insurance industry, *Munich* involved a dispute between an insurer and a reinsurer. *See id.* at 587–88. The relationship between the parties was thus analogous

to that between a primary policyholder and a primary insurer, and the dispute was "limited to entities within the insurance industry." *Pireno*, 458 U.S. at 129. The nexus to the "business of insurance" is thus substantially tighter in *Munich* than here.

The Second Circuit has also held that the McCarran-Ferguson Act reverse-preempted the FAA in the context of a reinsurance dispute, and it did so in a case involving the same Kentucky exclusive jurisdiction provisions at issue here. *Stephens v. Am. Int'l Ins. Co.*, 66 F.3d 41, 42 (2d Cir. 1995).[1] Like *Munich*, *Stephens* contains language suggesting that the McCarran-Ferguson Act broadly protects state anti-arbitration rules in insurer liquidation laws on the theory that it is "crucial" to the insured-insurer relationship that, "in the case of insolvency, the insurance company will be liquidated in an organized fashion." *Id.* at 44–45. But *Stephens* is more clearly bound to its facts. Indeed, the Second Circuit's analysis of the three-factor *Fabe/Pireno* test had everything to do with reinsurance: The court explained that (1) the insurer-reinsurer relationship is "principally the same" as that "between an original policyholder and an insurer, as both center around the transfer of risk"; (2) "reinsurance is not merely 'an integral part of the policy relationship between the insurer and insured,' it *is* the policy relationship between the two parties"; and (3) reinsurance is

---

[1] Kentucky's Liquidation Law has been since amended to address the reinsurance issue raised in *Stephens*. *See* Ky. Rev. Stat. Ann. § 304.33-010(6) (2010); 1996 Ky. Acts ch. 183, § 1. This change is immaterial here, however.

"'limited to entities within the insurance industry.'" *Id.* at 44 (quoting *Pireno*, 458 U.S. at 129).

The danger of *Munich* (and to a lesser extent, *Stephens*) thus arises not from its result, but from its rationale: that the McCarran-Ferguson Act protects any provision of a state liquidation law that bars access to any forum other than state courts. *Munich*, 141 F.3d at 592–95; *see also Stephens*, 66 F.3d at 44–45. Under this rule, it is immaterial how indirectly application of such an access-control law impacts the insured-insurer relationship. In *Davister*, the Tenth Circuit took *Munich*'s reasoning and ran with it, foreclosing arbitration of an ordinary tort suit between an insolvent insurer a third party outside the insurance industry. *Davister*, 152 F.3d at 1281. The Kentucky Supreme Court below did the same.

By contrast, the Sixth Circuit has expressly rejected *Munich*'s rule of law as "overly expansive." *AmSouth*, 386 F.3d at 783. So has the Fourth Circuit. In *Gross v. Weingarten*, 217 F.3d 208 (4th Cir. 2000), an insolvent insurer brought suit in federal court against a bank, but when the bank counterclaimed, the insurer pointed to *Munich* and asserted that federal jurisdiction was barred by the state's "efforts to establish a single equitable proceeding to liquidate or rehabilitate insolvent insurers." *Id.* at 222. The Fourth Circuit had none of it. The court rejected *Munich*'s reasoning because it "proves too much." *Id.* Instead, the Fourth Circuit held that exercise of concurrent jurisdiction over the bank's counterclaims did not "invalidate, impair, or supersede" the state's efforts to concentrate proceedings in the state liquidation court, as the banks could not enforce any

judgment on their counterclaims without participating in the liquidation. *Id.*

In *Garcia v. Island Program Designer, Inc.*, 4 F.3d 57 (1st Cir. 1993) (Breyer, J.), the First Circuit adopted a similarly measured approach, albeit on a different fact pattern. In *Garcia*, the First Circuit held that Puerto Rico could not penalize the federal government for failing to comply with a filing deadline for creditors of an insolvent insurer by sending federal claims "to the end of the priority queue." *Id.* at 58.[2] The filing deadline "helps policyholders only to the extent that (and in the same way as) it helps all creditors," by "bring[ing] about more speedy, orderly liquidation proceedings." *Id.* at 62. Without it, liquidation would become "slightly more difficult." *Id.* The deadline thus "provides policyholders with only indirect, speculative benefit of the kind that the *Fabe* Court found far too tenuous to prevent pre-emption." *Id.* The anti-arbitration rule here is clearly different from the filing deadline in *Garcia*. But if the Kentucky Supreme Court had employed similar reasoning, however — refusing to protect an "indirect, speculative benefit" shared by policyholders and other creditors — the Kentucky Supreme Court would likely have reversed, not affirmed.

---

[2] Puerto Rico is a "State" for purposes of the McCarran-Ferguson Act. 15 U.S.C. § 1015.

III. THIS IS AN EXCELLENT VEHICLE FOR RESOLVING AN IMPORTANT QUESTION REGARDING THE INTERPLAY BETWEEN THE MCCARRAN-FERGUSON ACT AND THE FAA

1. The decision below not only conflicts with *Fabe* and *AmSouth*, but also upsets the balance between the McCarran-Ferguson Act and the FAA and undermines the important policies of the FAA. The question of whether an ordinary tort suit between a rehabilitator and a potential third-party debtor should be arbitrated is far from the core of the McCarran-Ferguson Act — indeed, arbitrability of such a dispute is essentially irrelevant to policyholders.

But this question of arbitrability lies at the heart of the FAA. Congress enacted the FAA for the "central purpose" of "ensur[ing] that private agreements to arbitrate are enforced according to their terms." *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 53–54 (1995) (quotation marks omitted). This pro-arbitration federal policy marked a dramatic shift away from "centuries of judicial hostility to arbitration agreements." *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 510 (1974). "[F]irst and foremost," the FAA's aim was to "change this antiarbitration rule." *Allied-Bruce*, 513 U.S. at 270–71 (quotation marks omitted).

The Kentucky Supreme Court evinced precisely the judicial hostility to arbitration that Congress intended the FAA to override. The Kentucky Supreme Court explained that arbitration would lead to "[p]iecemeal adjudication" and a "potential for

inconsistent verdicts," and would unduly restrict the state court's review. App. 16. Indeed, it was this hostility to arbitration's perceived tendency to interfere with ordinary judicial administration — not anything having to do with the business of insurance — that drove the court's reasoning.

This Court has rejected these very same reasons as a basis for refusing arbitration. "[F]ederal law *requires* piecemeal resolution when necessary to give effect to an arbitration agreement." *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S . 1, 20 (1983). An arbitration clause must be enforced as drafted even when arbitration would bifurcate otherwise intimately intertwined proceedings, thereby leading to inefficiency and potential inconsistencies. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218, 221–22 (1985). The intent of the parties, not efficiency, is the paramount concern. *Id.* at 221. And "although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of [a] statute." *McMahon*, 482 U.S. at 232. The Kentucky Supreme Court's decision does little to further Congress's goals in enacting the McCarran-Ferguson Act — but it directly counters the policies that undergird the FAA.

This Court has routinely intervened to ensure that judicial skepticism of arbitration does not frustrate the objectives of the FAA and the value of bargained-for agreements to arbitrate. Arbitration is particularly important to the accounting profession, as many accounting disputes involve the application of professional judgment to highly complex and indeterminate rules. *See Shalala v. Guernsey Mem'l*

Hosp., 514 U.S. 87, 101 (1995). At the same time, auditors are attractive litigation targets in hindsight whenever an audit client has unexpected financial difficulties. *See, e.g., Bily v. Arthur Young & Co.*, 834 P.2d 745, 763 (Cal. 1992).

2. This is an unusually good vehicle for addressing whether the McCarran-Ferguson Act reverse preempts the FAA as to arbitration of an ordinary tort suit between a rehabilitator and a third party. But for the Kentucky Supreme Court's interpretation of the McCarran-Ferguson Act, the FAA would indisputably command arbitration. In the separate class action suit brought against Ernst & Young, in which the McCarran-Ferguson Act was not invoked, the Kentucky Supreme Court held that the FAA compelled arbitration of precisely the same arbitration clause. App. 25. In the Rehabilitator's suit, by contrast, the Kentucky Supreme Court relied exclusively on McCarran-Ferguson Act as the basis for refusing to arbitrate. App. 19–20. This petition thus squarely presents the question of whether the Kentucky Supreme Court's expansive interpretation of the McCarran-Ferguson Act can be reconciled with *Fabe* — and whether its anti-arbitration policies are immune from the FAA's command.

CONCLUSION

For the foregoing reasons, this Court should grant the petition for certiorari.

RESPECTFULLY SUBMITTED

PAUL D. CLEMENT
Counsel of Record
JOHN A. CHANDLER
ZACHARY D. TRIPP
KING & SPALDING LLP
1700 Pennsylvania Ave. NW
Washington, DC 20006
pclement@kslaw.com
(202) 737-0500

BRUCE M. CORMIER
Associate General Counsel
ERNST & YOUNG LLP
1101 New York Ave. NW
Washington, DC 20005
(202) 327-7603

November 22, 2010 *Counsel for Petitioners*

APPENDIX

TABLE OF APPENDICES

Appendix A

Opinion of the Supreme Court of Kentucky, dated August 26, 2010 ..... App-1

Appendix B

Order Granting Transfer & Consolidation, Supreme Court of Kentucky, dated April 24, 2008 ..... App-27

Appendix C

Opinion and Order Denying Motion to Compel Arbitration, Franklin Circuit Court Second Division, dated September 13, 2007 ..... App-29

Appendix D

U.S. Const, Art. VI, cl. 2 ..... App-41

Relevant Provisions of Ky. Rev. Stat. Ann.

Ky. Rev. Stat. Ann. § 304.33-010 ..... App-42

Ky. Rev. Stat. Ann. § 304.33-030 ..... App-45

Ky. Rev. Stat. Ann. § 304.33-040 ..... App-50

Ky. Rev. Stat. Ann. § 304.33-140 ..... App-56

Ky. Rev. Stat. Ann. § 304.33.160 ..... App-61

Appendix E

Affidavit of David S. Meyer, dated April 18, 2005, attaching Engagement Letter containing mandatory arbitration clause, dated July 22, 2002 ..... App-63

Appendix A

Rendered: Aug. 26, 2010

SUPREME COURT OF KENTUCKY

Nos. 2007-SC-000770-TG, 2007-SC-000936-TG

ERNST & YOUNG, LLP & David S. Meyer,

Appellants

v.

Sharon P. CLARK (In Her Official Capacity as Commissioner for the Kentucky Department of Insurance and Rehabilitator of AIK Comp); Stephen P. Lattanzio; Actuarial & Technical Solutions, Inc.; and John and Jane Does, all Unknown Actuaries and Accountants,

Appellees

and

ERNST & YOUNG, LLP,

Appellant

v.

APPALACHIAN REGIONAL HEALTHCARE, INC.; Apollo Oil, LLP; Art's Electric, Inc.; Crittenden Health Systems; European Design, Inc.; Fischer Special Manufacturing Company; Gallatin Health Care, LLC; Hopewell Farm, LLC; Louden & Company, LLC; M & M Cartage, Inc.; Modco Transport; and Pattie A. Clay Regional Medical Center,

Appellees

Opinion of the Court by Justice VENTERS

Affirming in Part and Reversing in Part

This appeal arises out of the insolvency of AIK Comp, a workers' compensation self-insurance group, and the efforts of the Rehabilitator appointed pursuant to Kentucky's "Insurers Rehabilitation and Liquidation Law"[1] (IRLL) to assert tort claims on behalf of AIK Comp against Appellants, Ernst & Young LLP, and others. Similar claims against Appellants were also asserted by the individual members of AIK Comp[2] in a class action. The Franklin Circuit Court entered orders in each case denying Ernst & Young's motion to enforce contractual provisions calling for such claims be submitted to "binding arbitration." Appeals from those orders were consolidated and transferred to this Court. Two issues are presented: first, whether the arbitration agreements in Ernst & Young's contracts with AIK Comp may be enforced against the Rehabilitator; and second, whether the same arbitration agreements force the plaintiffs in the class action to arbitrate their claims against Ernst & Young.

We hold that the arbitration agreements are not enforceable over the Rehabilitator's objection and affirm that order of the Franklin Circuit Court. However, for reasons set forth in section III of this

---

[1] KRS 304.33-010 to 304.33-600.

[2] There are numerous plaintiffs in the class action. These plaintiffs include: Appalachian Regional Healthcare, Inc.; Apollo Oil, LLP; Art's Electric, Inc.; Crittenden Health Systems; European Design, Inc.; Fischer Special Manufacturing Company; Gallatin Health Care, LLC; Hopewell Farm, LLC; Louden & Company, LLC; M & M Cartage, Inc.; Modco Transport; and Pattie A. Clay Regional Medical Center.

opinion, we conclude that the circumstances that require the Rehabilitator's claims to remain in the Franklin Circuit Court are not applicable to the class action claims, and thus those claims are subject to the arbitration requirements. Accordingly, we reverse that order of the Franklin Circuit Court.

I. FACTUAL AND PROCEDURAL BACKGROUND

AIK Comp (formerly known as Associated Industries of Kentucky Selective Self-Insurance Fund) is a workers' compensation self-insured group organized under KRS 342.350,[3] to provide its member-employers with the workers' compensation insurance required by KRS 342.340. At all times relevant to this action, KRS 342.347(1)[4] mandated the Commissioner of the Kentucky Department of Insurance (now the Executive Director of the Kentucky Office of Insurance) to periodically examine the financial condition of workers' compensation self-insured groups. KRS 342.347(2) required each self-insurance workers' compensation group, including AIK Comp, to be annually audited by an independent certified public accountant and to file with the Commissioner a detailed statement of its financial condition as disclosed by the audits. The statute specified the

---

[3] In 2005, after the failure of AIK Comp and after the audits that are the subject of this litigation, the General Assembly enacted KRS 304.50-010 to 304.50-160 which recodified, and in some instances modified, the regulation of workers' compensation self-insured groups previously covered by KRS 342.350.

[4] Note that KRS 304.50-075, effective March 1, 2005, specifically calls for review of each workers' compensation self-insured groups' financial condition every four years by the Executive Director of the Office of Insurance.

particular information to be included in the annual statement of financial condition.[5] KRS 342.347(5) required the insurance Commissioner to "make such recommendations to the Governor and legislative committees as may be appropriate to strengthen the oversight of self-insureds so that payment of liabilities to workers under this chapter is assured."

In 1999 and each year thereafter through 2003, the Chief Executive Officer of AIK Comp, Maurice Turner, and a representative from Ernst & Young, David S. Meyer, executed a written agreement (the "engagement letters") whereby Ernst & Young LLP, a certified public accounting and auditing firm, agreed to provide accounting services for AIK Comp to satisfy the statutory auditing and reporting requirements. Each engagement letter called for Ernst & Young to audit AIK Comp's finances for the previous fiscal year. A mediation and arbitration clause was included in the first engagement letter, and was thereafter incorporated by reference in the subsequent engagement letters. For the audits completed for fiscal years 1998 to 2001, the arbitration clause stated as follows:

> [a]ny controversy or claim arising out of or relating to the services covered by this letter or hereafter provided by us to the Company (including any such matter involving any parent, subsidiary, affiliate, successor in interest, or agent of the Company or of Ernst & Young LLP) shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding

---

[5] KRS 304.50-110 now provides substantially similar reporting requirements.

> arbitration, in accordance with the dispute resolution procedures set forth in the attachment to this letter. Judgment on any arbitration award may be entered in any court having proper jurisdiction.

The dispute resolution procedures set forth in the attachment included a choice of law provision requiring that any dispute regarding the validity of the arbitration clause would "be governed by the Federal Arbitration Act."

In July 2002, Ernst & Young and AIK Comp executed another engagement letter, which applied to the audits for fiscal years 2002 and 2003 and contained the following, slightly different arbitration provision:

> [a]ny controversy or claim arising out of or relating to services covered by this letter or hereafter provided by us for the Fund or at its request (including any such matter involving any parent, subsidiary, affiliate, successor in interest, or agent of the Fund or of Ernst & Young LLP, *or involving any person or entity for whose benefit the services in question are or were provided),* shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding arbitration, in accordance with the dispute resolution procedures set forth in the attachment to this letter. Judgment on any arbitration award may be entered in any court having jurisdiction. (emphasis added.)

The latter arbitration clause retained the choice of law provision requiring that any dispute "shall be governed by the Federal Arbitration Act." Later in 2003, Ernst & Young resigned as AIK Comp's auditor prior to

completion of the contract as outlined in the final engagement letter.

All of the audits completed by Ernst & Young for statutory submission by AIK Comp to Kentucky's insurance regulators indicated that the group was financially sound. The audits showed that AIK Comp maintained a positive fund surplus with sufficient assets and reserves to cover the liabilities that may arise from future workers' compensation claims. However, in 2004, a financial examination by a different accounting firm revealed that AIK Comp was in a deficit position and was unable to pay its claims. AIK Comp was subsequently placed in rehabilitation by order of the Franklin Circuit Court pursuant to KRS Chapter 304, and accordingly, a Rehabilitator[6] was appointed. The discovery of AIK Comp's insolvency brought into question the accuracy of the Ernst & Young audit reports and the competence of those who prepared them.

Eventually, a Reorganization Plan for AIK Comp was agreed upon by the Rehabilitator and by the numerous parties that had intervened in the rehabilitation. The Reorganization Plan was approved by the Franklin Circuit Court in December 2005. To finance most of AIK Comp's $90,000,000 deficit and to assure payment of the claims of injured workers, the Rehabilitation Plan required that the employers that comprised the membership of AIK Comp be assessed a

---

[6] Martin Koetters was the first Rehabilitator. He was succeeded by R. Glenn Jennings, who was succeeded by Julie Mix McPeak. Clark then replaced McPeak. To avoid confusion, we will use feminine pronouns to refer to the Rehabilitator throughout the opinion since Sharon P. Clark currently holds the position.

proportional share of the deficit. The Reorganization Plan also provided for the Rehabilitator to "aggressively pursue" claims against those "[s]he holds responsible for the current problems faced by AIK Comp." Thus, pursuant to the Reorganization Plan and her power under KRS 304.33-160, the Rehabilitator filed suit against Ernst & Young and other parties[7] in the Franklin Circuit Court alleging that Ernst & Young's audits had been negligently prepared, and had concealed AIK Comp's declining financial condition. In addition, the members of AIK Comp that paid assessments to cover the financial deficit brought a separate suit against Ernst & Young and others in the Franklin Circuit Court, claiming that the assessments were necessitated by the alleged misrepresentations, omissions, and false statements made in the audits. The members' suits were consolidated into a class action.

In response, Ernst & Young filed motions in both cases to stay the proceedings and to compel arbitration in accordance with the arbitration clauses contained in the engagement letters described above. The Franklin Circuit Court denied the motions. Ernst & Young appealed. The Rehabilitator moved to transfer the appeal of her case from the Court of Appeals to this Court. Ernst & Young subsequently moved to transfer the appeal involving the members of AIK Comp to this Court. We granted the motions to transfer and consolidated the appeals.

---

[7] The Rehabilitator filed suit against Ernst & Young employee David S. Meyer, Actuarial & Technical Solutions, Inc. which performed actuarial services for AIK Comp between 1998 and 2003, and its agent Stephen Lattanzio.

At the outset, we note that the arbitration agreements entered into between Ernst & Young and AIK Comp are facially valid. *See General Steel Corp. v. Collins,* 196 S.W.3d 18, 20 (Ky. App. 2006) (holding that the validity of an arbitration agreement must be determined as a threshold matter) (citing *First Options of Chicago, Inc. v. Kaplan,* 514 U.S. 938 (1995)). The engagement letters clearly contain agreements to arbitrate, and there is every indication that the elements of valid contract formation were satisfied.

Because the agreements explicitly require that disputes be governed by the Federal Arbitration Act, 9 U.S.C. § 1, *et. seq.*, we need not consider Kentucky's Uniform Arbitration Act, KRS 417.045 *et. seq.*[8] *Conseco Finance Servicing Corp. v. Wilder,* 47 S.W.3d 335, 341 (Ky. App. 2001) (citing *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University,* 489 U.S. 468 (1989)) (stating that choice of law provisions in arbitration agreements are to be generally upheld).

---

[8] Under the Kentucky's "Uniform Arbitration Act", KRS 417.045-417.240, the arbitration clauses at issue would be unenforceable since they do not specifically provide for the arbitration to occur in this state. *Ally Cat, LLC v. Chauvin,* 274 S.W.3d 451, 455 (Ky. 2009) (holding that the plain language of KRS 417.200 only allows enforcement of arbitration agreements which specifically state that the arbitration is to be held in Kentucky). *Ally Cat* has no applicability to an arbitration agreement governed exclusively by the Federal Arbitration Act.

II. THE ARBITRATION AGREEMENT BETWEEN ERNST & YOUNG AND AIK COMP IS NOT ENFORCEABLE AGAINST THE REHABILITATOR

Ernst & Young first argues that the Franklin Circuit Court erroneously denied its motion to compel arbitration of the Rehabilitator's suit. The Franklin Circuit Court order held that arbitration could not be compelled against the Rehabilitator because: 1) the IRLL gives the Franklin Circuit Court broad discretion to retain full jurisdiction of the rehabilitation of AIK Comp, including any lawsuits filed by the Rehabilitator as part of the rehabilitation process; 2) the arbitration agreements do not cover all of the annual audits which the Rehabilitator alleges Ernst & Young performed negligently; 3) the Rehabilitator was not a signatory to any of the arbitration agreements; 4) the IRLL grants the Rehabilitator broad authority to exercise the state's "police powers," including the authority to revoke or rescind AIK Comp's valid arbitration agreements; and 5) the Federal Arbitration Act's preference for enforcing arbitration agreements is subordinated to the IRLL by the reverse-preemption doctrine of the McCarran-Ferguson Act, 15 U.S.C. § 1011, *et. seq.*

Ernst & Young argues that the Franklin Circuit Court order failed to recognize the supremacy of the Federal Arbitration Act and its establishment of a national policy favoring the arbitration of disputes. We do not disagree. However, we conclude that the trial court correctly found that the IRLL's broad grant of exclusive jurisdiction to the Franklin Circuit Court in matters relating to the delinquency of insurance

companies preempts and supersedes the Federal Arbitration Act and its policy favoring arbitration.

A. Reverse Preemption of the Federal Arbitration Act Under The McCarran-Ferguson Act—The *Forsyth* Test

KRS 304.33-010(6), one of the initial provisions of the IRLL, states:

> [i]f there is a delinquency proceeding under this subtitle, the provisions of this subtitle shall govern those proceedings, and all conflicting contractual provisions contained in any contract between the insurer which is subject to the delinquency proceeding and any third party shall be deemed subordinated to the provisions of this subtitle. However, notwithstanding the foregoing, in any delinquency proceeding commenced against an insurer after July 15, 1996, nothing in this subtitle shall be construed to subordinate or restrict the rights of parties to submit their disputes to arbitration pursuant to a contractual arbitration clause contained in a reinsurance agreement.

"Delinquency proceeding," as defined by KRS 304.33-030(5), includes "any proceeding commenced against an insurer for the purpose of . . . rehabilitating . . . such insurer." Consequently, any provisions of the agreements between Ernst & Young and AIK Comp that conflict with KRS 304.33 "shall be subordinated to the provisions of [KRS subtitle 304.33, the IRLL]" unless as Appellants argue, the Federal Arbitration Act preempts KRS 304.33-010(6). "Under the conventional application of the supremacy clause and rules of statutory construction, the Federal Arbitration

Act, a federal statute, would preempt Kentucky's Liquidation Act, a state statute,[9] insofar as the Liquidation Act contravenes the Federal Arbitration Act." *Stephens v. American Int'l Ins. Co.*, 66 F.3d 41, 43 (2d Cir.1995). However, the McCarran-Ferguson Act, 15 U.S.C. § 1011, *et seq.*, establishes a doctrine of "reverse preemption" that expressly exempts from federal preemption state statutes enacted to regulate insurance, leaving the regulation of insurance to the individual state. Under McCarran-Ferguson, "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such [federal] Act specifically relates to the business of insurance." 15 U.S.C. § 1012(b) (1994). The United States Supreme Court created a three-part test to determine when reverse preemption of federal law through McCarran-Ferguson occurs. The test is whether: 1) the state statute was enacted for the purpose of regulating the business of insurance; 2) the federal statute involved "does not specifically relat[e] to the business of insurance"; and 3) the application of the federal statute would "invalidate, impair, or supersede" the state statute regulating insurance. *Humana Inc. v. Forsyth*, 525 U.S. 299, 307 (1999).

In this matter, the first step of the *Forsyth* test is clearly satisfied. There can be no reasonable doubt that the IRLL, of which KRS 304.33-010(6) is a part, was enacted to regulate the "business of insurance." *Stephens*, 66 F.3d at 41; *National Home Ins. Co. v.*

---

[9] The Court in *Stephens* adopted the term "the Kentucky Liquidation Act" as a shorthand reference for the Kentucky Insurers Rehabilitation and Liquidation Law, KRS 304.33-010 *et seq. Stephens*, 66 F.3d at 42.

King, 291 F.Supp.2d 518 (E.D. Ky. 2003). We can hardly overstate the degree to which the regulation of insurance permeates this controversy. The very claims which Ernst & Young would take to arbitration arise directly out of Kentucky's intense interest in the regulation of worker's compensation insurance. The audits that form the core of the Rehabilitator's claims were performed by Ernst & Young for AIK Comp to comply with state insurance regulations which include a review of such audits by the state's insurance commissioner to monitor the solvency of AIK Comp. The IRLL is itself the ultimate measure of the state's regulation of the insurance business: the take-over of a failing insurance company.

The second step of the *Forsyth* test is satisfied because the Federal Arbitration Act does not "specifically relat[e] to the business of insurance." *See Munich Am. Reinsurance Co. v. Crawford*, 141 F.3d 585, 590 (5th Cir. 1998); *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277, 1279 (10th Cir. 1998).

The third step of the *Forsyth* test presents the question of whether the application of a federal law, in this case the Federal Arbitration Act, would "invalidate, impair, or supersede" provisions of a state statute regulating insurance, the IRLL. In essence, this returns us to KRS 304.33-010(6) because the question of whether the Federal Arbitration Act (with its strong preference for arbitration) "invalidates, impairs, or supersedes" a state law regulating insurance is, as a practical matter, virtually the same question we started with: whether the arbitration clauses of the engagement letters conflict with any provisions of the IRLL. If, as the Rehabilitator argues,

arbitration is inconsistent with parts of the IRLL, then KRS 304.33-010(6) commands that the arbitration clauses be overridden, and for that same reason, the final part of the *Forsyth* test would be satisfied.

B. The Arbitration Clauses and the FAA Conflict with the IRLL's Grant of Broad Exclusive Jurisdiction to the Franklin Circuit Court

Enforcement of the arbitration clauses found in the engagement letters between Ernst & Young and AIK Comp conflicts with the IRLL. We are directed by KRS 304.33-010(3) to liberally construe the provisions of the IRLL to effect the purposes stated in KRS 304.33-010(4). KRS 304.33-010(4)(c) expressly states that one of the purposes of the IRLL is the "enhanced efficiency and economy of liquidation, through the *consolidation of matters relating to the liquidation under the supervision of a single court* so as to avoid divergent rulings by a multiplicity of judicial tribunals . . . ." (emphasis added). KRS 304.33-040(3)(a) provides that "the [Franklin Circuit] court[10] shall have exclusive jurisdiction to entertain, hear, or determine all matters in any way relating to any delinquency proceeding under this subtitle, including, but not limited to, all disputes involving purported assets of the insurer." KRS 304.33-040(3)(b) allows the Franklin Circuit Court to "authorize a rehabilitator[11] to seek injunctive

---

[10] The actual word used in KRS 304.33-040 is "court." However, KRS 304.33-030 defines court as the "Franklin Circuit Court."

[11] The statute uses the word "receiver" which at KRS 304.33-030(3) is defined to include a "receiver, liquidator, rehabilitator, or conservator, as the context requires."

or other appropriate relief from other courts, either within this state or without this state, if in the opinion of the [Franklin Circuit] court, this action will be an aid to any delinquency proceeding."

Similarly, KRS 304.33-140(2) provides:

> (2) Upon the issuance of an order directing the executive director to rehabilitate a domestic insurer, the [Franklin Circuit] court shall have exclusive jurisdiction over all matters relating to the rehabilitation, including, but not limited to, the proper scope and application of the provisions of this subtitle to the rehabilitation as well as all interpretation and enforceability of all contracts of insurance to which the insurer is a party.

Exclusive jurisdiction over "*all matters in any way relating to* any delinquency proceeding . . . including . . . all disputes involving purported assets of the insurer"[12] and over "*all matters relating to* the rehabilitation"[13] is an extremely broad grant of authority by the General Assembly to the Franklin Circuit Court. Such broadly defined exclusive jurisdiction, coupled with directions for liberal construction, is a very rare, if not unique, provision in Kentucky law. We have on other occasions in another context noted the broad scope of this jurisdictional grant:

> The subtitle provides Franklin Circuit Court broad discretion as to supervision of the proceedings. KRS 304.33-040 pertains to the

---

[12] KRS 304.33-040(3)(a).

[13] KRS 304.33-140(2).

> exclusiveness of proceedings and states that the court shall have exclusive jurisdiction over all matters relating to the proceeding, including all disputes over assets. The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the subtitle. Section (3)(c) states that no provisions in the subtitle shall be construed to preclude the court from, on its own motion, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules or to prevent an abuse of process.

Kentucky Central Life Ins. Co. v. Stephens, 897 S.W.2d 583, 587 (Ky. 1995); *see also Minor v. Stephens*, 898 S.W.2d 71, 80 (Ky. 1995).

It is evident that an essential goal of the IRLL is to promote consistent rulings in all matters that impact the rehabilitation of an insurance company. We believe that the strong language of KRS 304.33-040(3)(a) and KRS 304.33-140(2) is an unambiguous expression of the General Assembly's intention to achieve that goal by concentrating in the Franklin Circuit Court "all matters in any way related" to the proceeding to rehabilitate or liquidate an insurance company. The vesting of such jurisdiction in the Franklin Circuit Court, including the broad authority to supervise all issues relating to a rehabilitation, provides a logical and reasonable means of attaining the IRLL's stated purpose of achieving "enhanced efficiency and economy of liquidation, through the consolidation of matters relating to the liquidation under the supervision of a single court so as to avoid divergent rulings by a multiplicity of judicial tribunals." KRS 304.33-010(4)(c)).

Compelling the enforcement of the arbitration agreements in this case would remove virtually all of the supervisory authority of the Franklin Circuit Court over the adjudication of the Rehabilitator's claims against Ernst & Young and place it in the hands of the arbitrators. Thus, all discovery issues, evidentiary disputes, and determinations of applicable law would be made by the arbitrators, not by the court as the General Assembly intended.

Inconsistent and incompatible results are possible if the Rehabilitator's claims against Ernst & Young are resolved by arbitration, while other issues pertaining to the AIK Comp rehabilitation are adjudicated in the Franklin Circuit Court. Piecemeal adjudication and the potential for inconsistent verdicts are what the General Assembly sought to avoid by the IRLL's strong grant of exclusive jurisdiction to the Franklin Circuit Court.

Ernst & Young argues that the potential for such inefficiencies is not relevant to the enforceability of valid arbitration agreements, and cites cases that discount such concerns in favor of arbitration.[14] We recognize the validity of the cited authority, but we note that they do not involve arbitration in the context of a proceeding to liquidate or rehabilitate an insurance company, with the extraordinary state interest vested therein; nor, do they involve the strong statutory preference for the resolution of such matters in a specific forum that we find in the IRLL.

---

[14] *Dean Witter Reynolds, Inc. v. Byrd,* 470 U.S. 213 (1985); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.,* 460 U.S. 1 (1983).

Ernst & Young also argues KRS 304.33-010(6) does not apply in this case because the Rehabilitator's lawsuit is not a "delinquency proceeding." *See Nichols v. Vesta Fire Ins. Corp.*, 56 F.Supp.2d 778 (E.D. Ky. 1999) (holding that an insurance Rehabilitator's breach of contract suit filed against a third-party insurer was merely a "garden variety" lawsuit, not a delinquency proceeding in which KRS 304.33-010(6) would apply). On this point, we first note that KRS 304.33-010(6)'s subordination of contractual provisions that conflict with the IRLL is not limited to the "delinquency proceeding." By the plain language of KRS 304.33-010(6), any contractual provision in conflict with the IRLL is subordinated "*[i]f there is a delinquency proceeding under this subtitle . . .*" (emphasis added). That there is, in fact, a delinquency proceeding in the Franklin Circuit Court regarding AIK Comp cannot be disputed, and as part of that proceeding under KRS 304.33-160(4), the Rehabilitator has been charged to "pursue all appropriate legal remedies on behalf of the insurer."

Secondly, the federal court in *Nichols* found that the exclusive jurisdiction granted by KRS 304.33-040 to the Franklin Circuit Court was inapplicable because the claim involved was simply a "common law breach of contract action which merely happens to involve an insolvent insurer." *Nichols*, 56 F.Supp.2d. at 780. "[T]he instant action is no more than a garden variety contract suit which happens to involve two insurers. The fact that one is insolvent is irrelevant[.]" *Id.* at 781. Far from being just a coincidental aspect of a "garden variety" claim, AIK Comp's insolvency was allegedly caused by Ernst & Young's audits which masked AIK Comp's true financial condition. Under the Reorganization Plan approved by the Franklin

Circuit Court, the Rehabilitator's claims against Ernst & Young are an essential component of AIK Comp's rehabilitation. Unlike the claims in *Nichols*, the claims asserted by the Rehabilitator fall squarely within the scope of KRS 304.33-040(3)(a), as "matters . . . relating to [a] delinquency proceeding under this subtitle, including . . . all disputes involving purported assets of the insurer," and therefore, under KRS 304.33-010(6) remain within the exclusive jurisdiction of the Franklin Circuit Court.

We therefore conclude that the contractual provisions for arbitration under the Federal Arbitration Act are in conflict with the jurisdictional requirements of the IRLL. In reaching this conclusion, we reject Ernst & Young's comparison of that result to the anti-arbitration concept of "ouster of jurisdiction," a doctrine discredited in *Fite & Warmath Construction Co. v. MYS Corp.*, 559 S.W.2d 729, 735 (Ky. 1977), and *Kodak Min. Co. v. Carrs Fork Corp.*, 669 S.W.2d 917, 921 (Ky. 1984). We recognize that when a lawsuit is submitted to arbitration, the trial court technically retains jurisdiction over the proceeding while the issues are arbitrated. But, we also recognize that in such situations, the trial court no longer retains the authority to "determine all matters in any way related to the delinquency." KRS 304.33-040(3)(a). When a dispute goes to arbitration, the trial court's broad discretion to decide all issues pertaining to pre-hearing procedures, including discovery, all issues of substantive law, and all evidentiary matters passes to the arbitrator. 4 Am. Jur. 2d. *Alternative Dispute Resolution*, § 157-169 (2007). The trial court's function is constricted to the simple entry of a final judgment enforcing the arbitrator's decision. *See DiMercurio v. Sphere Drake, Ins., PLC*, 202 F.3d 71, 77 (1st Cir.

2000) (holding that "arbitration agreements do not divest courts of jurisdiction, though they prevent courts from resolving the merits of arbitrable disputes.") Only if the arbitrator's decision is alleged to have been tainted by fraud or favoritism does the trial court have the ability to intercede. *See Wall Street Associates, L.P. v. Becker Paribas Inc.*, 27 F.3d 845, 849 (2d Cir. 1994)(citing the Federal Arbitration Act, 9 U.S.C. § 10); *3D Enterprises Contracting Corp. v. Lexington-Fayette Urban County Government*, 134 S.W.3d 558, 561 (Ky. 2004) (citing KRS 417.160 of Kentucky's Uniform Arbitration Act). Such a substantial reduction of the court's role in a process central to the rehabilitation of an insurance company is inconsistent with our legislature's extensive grant of exclusive jurisdiction to the Franklin Circuit Court. The General Assembly did not intend for that grant of jurisdiction to be overruled by an insurance company's agreement to arbitrate issues critical to the state's interest in the rehabilitation or liquidation of the insurance company.

Therefore, we conclude that the third part of the *Forsyth* test is satisfied because the Federal Arbitration Act's preference for arbitration conflicts with, and impairs, the IRLL's grant of broad and exclusive jurisdiction to the Franklin Circuit Court. In this case, application of the McCarran-Ferguson Act reverse-preempts the Federal Arbitration Act. Pursuant to KRS 304.33-010(6), the federal policy favoring arbitration is subordinated to the state's superior interest in having matters relating to the rehabilitation of an insurance company adjudicated in the Franklin Circuit Court.

The Rehabilitator properly chose to initiate her claims against Ernst & Young in the Franklin Circuit

Court, and properly declined to submit the matter to arbitration. We affirm the court's order denying Ernst & Young's motion to compel arbitration of the Rehabilitator's claims.

III. THE CLASS ACTION PLAINTIFFS ARE BOUND BY THE ARBITRATION CLAUSES IN THE ENGAGEMENT LETTERS

Ernst & Young next argues that the Franklin Circuit Court erred by denying its motion to compel arbitration of the members' class action lawsuit. The Franklin Circuit Court denied the motion for the following reasons: 1) the court believed the plaintiffs' claims against Ernst & Young were not covered by the arbitration clauses because they do not "arise out of or relate to" the services Ernst & Young performed pursuant to the engagement letters; 2) the class action plaintiffs had not signed the engagement letters containing the arbitration agreements, are not identified in the agreements as parties subject to the arbitration clauses, and are not otherwise bound under agency principles to the arbitration clauses; 3) the plaintiffs are not third-party beneficiaries to the engagement letters containing arbitration agreements; 4) the plaintiffs are not equitably estopped from disavowing the arbitration clauses; and 5) compelling arbitration of class action claims while the Rehabilitator's claims are litigated promotes the inefficiencies and confusion inherent in piecemeal adjudication.

We begin the analysis with the trial court's first reason and fifth reason as listed above because if either of those reasons validly supports its decision, our

consideration of the remaining issues becomes unnecessary.

A. The Plaintiffs' Claims Arise From the Services Ernst & Young Performed Pursuant to the Engagement Letters

The trial court justified its refusal to enforce the arbitration clauses in the engagement letters by holding that the clauses simply do not apply to the class action claims in question. We disagree. The arbitration clauses plainly state that they apply to "[a]ny controversy or claim arising out of or relating to services covered by this letter . . . ," the services being Ernst & Young's accounting and auditing for AIK Comp. Regardless of whether the class action claims are viewed as contract disputes or tort claims, or as something else, Ernst & Young's auditing and accounting services for AIK Comp are the basis for all of the claims. Thus, the plaintiffs' claims "arise out of" and "relate to" the services Ernst & Young were obligated by the engagement letters to render.

B. Inefficient Piecemeal Adjudication of Complex Litigation Does Not Authorize Avoidance of Agreements to Arbitrate

The trial court concluded that despite any basis upon which the class action plaintiffs might otherwise be bound by the arbitration clauses, arbitration of their claims should not be compelled because resolving the class action claims in a forum separate and apart from the adjudication of the Rehabilitator's claims unduly complicates an already complex matter, infusing it with the inefficiency of duplicative effort and the potential for inconsistent or incompatible results. Having previously noted that the claims of the

Rehabilitator and the claims of the class action plaintiffs are based upon the same allegations of deficient auditing by Ernst & Young, we do not doubt that separate adjudicative processes will substantially increase the burden in time and expense to witnesses and litigants.

However, as we also stated previously in this opinion, the Rehabilitator's claims involve the rehabilitation of an insurance company which is a matter of such compelling state interest that, under federal law, it transcends the applicability of the Federal Arbitration Act. Although the class action plaintiffs' claims and the Rehabilitator's claims arise from the same course of conduct, the class action claims are essentially private disputes with no substantial impact on the state's regulation of insurance. Joining the claims of the class action plaintiffs with the Rehabilitator's claims may promote judicial economy, but we do not see that it would promote the legislative policy embodied in KRS 304.33-010(4) for consolidating the various claims of the Rehabilitator. Without an overarching state interest to the contrary, the class action plaintiffs cannot avoid the forceful preference for arbitration found in the Federal Arbitration Act. The United States Supreme Court has decided the question in favor of the Federal Arbitration Act's national policy promoting arbitration. *See Dean Witter Reynolds, Inc. v. Byrd,* 470 U.S. 213, 217 (1985) (holding the Federal Arbitration Act requires arbitration of pendent arbitrable claims even where the result would be the inefficient maintenance of separate proceedings in different forums); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.,* 460 U.S. 1, 20 (1983) (holding that under the Federal Arbitration Act, an arbitration agreement

must be enforced even though it results in piecemeal litigation by other persons who are parties to the underlying dispute but not to the arbitration agreement.) We perceive that the federal policy allows no accommodation for the situation present here. Thus we conclude that the trial court erred by finding that arbitration could be denied on the grounds of judicial economy.

C. The Class Action Plaintiffs Gave Assent to the Arbitration Clause via their Application for AIK Comp Membership

None of the class action plaintiffs actually signed the engagement letters. However, Ernst & Young argues that each of the class action plaintiffs is nevertheless bound to the arbitration agreements because upon joining AIK Comp, each executed a membership application giving assent to be bound by AIK Comp's contracts. The argument, although presented by Ernst & Young to the trial court, is not mentioned in the order denying the motion to arbitrate. However, we agree that the assent given in the membership application binds the class action plaintiffs to the arbitration clauses.

In the membership application, each class action plaintiff upon joining AIK Comp agreed to "appoint AIK Comp and its trustees to act as [its] agent[s] in all matters relating to Kentucky Workers' Compensation Statutes" and "to abide by the rules, regulations and by-laws of [AIK Comp] and *to conform to the terms of the agreements they may enter into with any authorized service company* " for as long as membership in AIK Comp was maintained. (emphasis added.) Ernst & Young reasons that since AIK Comp's annual audits

are matters "relating to Kentucky Workers' Compensation Statutes," Maurice Turner[15] acted as an agent of each member when he executed the engagement letters.

First, we do not agree with Ernst & Young's argument that AIK Comp acted as the agent of its members when it executed the engagement letters. Under basic agency principles, an agent acts on the principal's behalf and is subject to the principal's control. *See Restatement (Third) Of Agency § 1.01* (2006). The audit requirement of KRS 342.347(2)[16] pertains only to AIK Comp. AIK procured the audits for itself, not as an agent on behalf of the individual members. As employers, the members are bound by Kentucky's workers' compensation laws, but they have no duty to obtain an audit and therefore have no need of an agent in obtaining one. In signing the engagement letters, Turner was not acting as an agent of the class action plaintiffs. We construe that language of the membership application as simply enabling AIK Comp to act as agent for the individual members in the processing and settlement of worker compensation claims, just as traditional workers' compensation insurers act as agents of the parties they insure to resolve workers' compensation issues.

Ernst & Young's second argument, that the member application compels each member of AIK Comp "to conform to the terms of the agreements [AIK Comp] may enter into with any authorized service company," is well taken. We are presented with no sound rationale by which we may conclude otherwise.

---

[15] Chief Executive Officer of AIK Comp.

[16] Now KRS 304.50-110.

The plaintiffs do not contend that Ernst & Young is not an "authorized service company." By accepting membership in AIK Comp, the class action plaintiffs agreed to "conform" to AIK Comp's agreements. We find no basis upon which to distinguish the arbitration clauses of the engagement letters from any other agreement with a service company, and thus conclude each class action plaintiff, under the terms of the membership application, agreed to "conform" to AIK Comp's agreements with Ernst & Young, including the agreement that claims or controversies arising from Ernst & Young's services be submitted to arbitration.

Accordingly, we reverse the trial court's order denying Ernst & Young's motion to compel arbitration of the class action claims. Because of that resolution, we need not address Ernst & Young's argument that the class action plaintiffs are third-party beneficiaries under the agreements and are otherwise equitably estopped from disavowing the agreements.

D. The Other Entities Listed in the Arbitration Clauses are not Bound Thereby

The class action plaintiffs argue that the 2002 modification to the engagement letter, which purports to add "any person or entity for whose benefit the services in question are or were provided" to the list of parties required to arbitrate, is a clear indication that they were excluded from the arbitration clauses in the 1998-2001 engagement letters. We are not persuaded however, because we do not read the agreements as establishing a list of collateral parties to be bound thereby. The list of other entities in the arbitration clauses does not purport to identify the parties that

must submit to arbitration. Literally read, it simply includes as among the kinds of disputes that AIK Comp must arbitrate, controversies that "involve" the listed entities. The listing of such entities is of no significance in the resolution of the issues presented herein, and the 2002 modification provides no relief to the class action plaintiffs.

IV. CONCLUSION

For the reasons set forth above, we affirm the Franklin Circuit Court's order in Civil Action No. 05-CI-00344 denying the Appellants' demand for arbitration of the claims brought against it by the AIK Comp Rehabilitator, and we reverse the Franklin Circuit Court's order in Civil Action No. 05-CI-00455 denying the Appellants' motion to compel arbitration of the claims of Appalachian Regional Healthcare, Inc. and the other class action plaintiffs. Accordingly, we remand this matter to the Franklin Circuit Court for entry of an order compelling arbitration of the class action lawsuit and for further proceedings in the adjudication of the Rehabilitator's claims.

All sitting. All concur.

SUPREME COURT OF KENTUCKY

No. 2007-SC-000770-T

Court of Appeals
No. 2007-CA-002050
Franklin Circuit Court No. 05-CI-00455

ERNST & YOUNG LLP, ET AL.

Appellants

v.

JULIE MIX McPEAK (EXECUTIVE DIRECTOR, KENTUCKY OFFICE OF INSURANCE AS REHABILITATOR OF AIK COMP, FOR AND ON BEHALF OF AIK COMP), ET AL.

Appellees

Order Granting Transfer & Consolidation

The motion to transfer this appeal from the Court of Appeals to the Supreme Court is hereby GRANTED and this case is hereby consolidated with *Ernst & Young v. Appalachian Regional Healthcare, et al.*, 2007-SC-000936-T.

The Clerk of the Court of Appeals is directed to forthwith transfer to this Court all of the records and files on appeal.

The parties shall comply with the briefing schedule as specified in CR 76.12. This case shall be subsequently set for oral argument.

All sitting. All concur.

ENTERED: April 24, 2008.

CHIEF JUSTICE
JOSEPH E. LAMBERT

Entered: Sept. 13, 2007

COMMONWEALTH OF KENTUCKY
Franklin Circuit Court
Division No. II

Civil Action No. 05-CI-455

JULIE MIX McPEAK (EXECUTIVE DIRECTOR, KENTUCKY OFFICE OF INSURANCE AS REHABILITATOR OF AIK COMP, FOR AND ON BEHALF OF AIK COMP),

Plaintiff

v.

ERNST & YOUNG LLP,

Defendants

Opinion & Order

This matter is before the Court upon Defendants, Ernst & Young, LLP's ("E&Y") motion for an Order staying this action and compelling arbitration. The Court having considered the record, having heard the arguments of counsel, and being otherwise sufficiently advised, issues the following Opinion and Order:

Facts

E&Y provided auditing services to AIR Comp, f/k/a Associated Industries of Kentucky Selective Self-Insurance Fund ("AIK") from 1998 to 2003. E&Y asserts that it entered into a contract with AIK to

provide auditing services for the years 2001 - 2003 which contained a prescribed dispute resolution agreement, E&Y contend this dispute resolution agreement requires AIK (and in return Julie Mix McPeak, Executive Director, Kentucky Office of Insurance, as Rehabilitator ("Rehabilitator")) to participate in a mediation and then a final and binding arbitration.

As the result of a dispute between AIK and E&Y in 2003, E&Y discontinued its provision of auditing services to AIK. This dispute was not submitted to arbitration.

On March 29, 2005, the Rehabilitator filed suit against E&Y, David S. Meyer, Stephen P. Lattanzio, and Actuarial & Technical Solutions, Inc. pursuant to this Court's order that AIK be placed in Rehabilitation and KRS 304.33 et. seq. ("the Kentucky Insurance Code"). The Rehabilitator's allegations against E&Y include counts of negligence, negligent misrepresentation and violations of the Kentucky Insurance Code (preparing, filing with AIK's regulators and providing to the AIK group members deceptive, unfair and misleading financial statements which misrepresented the true financial condition of AIK). The Rehabilitator claims this pattern of conduct began in 1998 when E&Y began providing auditing services and continued in each year up to and including 2003.

The Rehabilitator has also filed suit against AIK Inc. and former officers and trustees of AIK. The Rehabilitator's allegations against those parties include counts of negligence, negligent misrepresentation, breach of fiduciary duties and unjust enrichment.

E&Y filed a Motion for Order Staying this Action and Compelling Arbitration. E&Y argues that the Rehabilitator's claims are subject to an enforceable, written agreement, and that this Court should stay all claims against E&Y pending the arbitration of those claims.

The Rehabilitator contends this argument is flawed for many reasons. The Rehabilitator claims that E&Y alleged breach of the contract in 2003 and failure to pursue arbitration voided any enforceable arbitration agreement against AIK. In addition, the Rehabilitator claims that any agreement which could be enforceable against AIK compelling arbitration may not be applied to additional years (i.e., E&Y claim that the agreement to arbitrate covers years 2001, 2002 and 2003, but a dispute exists as to years 1998 - 2003). The Rehabilitator also claims that she may not be called upon to answer for AIK in relation to arbitration agreements because she was not a signatory and she does not "stand in the shoes" of the former AIK as E&Y contend. Last but not least, the Rehabilitator claims that as a result of the Commonwealth's police power and the statutory grant of power within the Kentucky Insurance Code, she may revoke or rescind any existing and valid arbitration agreements entered into by AIK prior to its placement in rehabilitation in order to further a compelling public and governmental interest. This Court agrees.

Discussion

1. This Court has the Discretion to Retain Full Jurisdiction of the Rehabilitation Action Pursuant to KRS 304.33-040.

The Kentucky Insurance Code (US 304.33 *et seq.)* regulates the performance of an insurer's contracts once an insurer or self-insurance group is placed into rehabilitation. The Kentucky Insurance Code provides the Franklin Circuit Court "broad discretion" as to supervision of the rehabilitation of AIK Comp. Specifically, KRS 304.33-040 clearly states that the Court shall have exclusive jurisdiction over all matters relating to the rehabilitation of AIK Comp. *See Minor v. Stephens,* 898 S.W.2d 71, 78 (Ky. 1995); *see also* KRS 304.33-040. KRS 304.33-010(6)[1] makes it clear that the Kentucky insurance Code exclusively governs the rehabilitation of AIK. The statute renders arbitration clauses unenforceable during rehabilitation because such clauses take control over important aspects of the rehabilitation away from this Court and take important proceedings outside of the Kentucky Insurance Code.

---

[1] If there is a delinquency proceeding under this subtitle, the provisions of this subtitle shall govern those proceedings, and all conflicting contractual provisions contained in any contract between the insurer which is subject to the delinquency proceeding and any third party shall be deemed subordinated to the provisions of this subtitle however, notwithstanding the foregoing, in any delinquency proceeding commenced against an insurer after July 15, 1996, nothing in this subtitle shall be construed to subordinate or restrict the rights of parties to submit their disputes to arbitration pursuant to a contractual arbitration clause contained in a reinsurance agreement.

KRS 304.33-040(3)(b) provides that "the court may authorize the receiver to seek injunctive or other appropriate relief from other courts, either within or without of state, if, *in the opinion of the court, this action will be an aid to any delinquency proceedings.*" (emphasis added). The Kentucky Insurance Code instructs this Court that traditional notions of *forum non conveniens* is an appropriate reason for the removal of the delinquency proceeding and/or ancillary matters from before this court.

The third party cause of action against E&Y is clearly a significant aspect of the rehabilitation of AIK Comp. AIK Comp is currently facing an enormous financial deficit that must be remedied. This Court can find no reason or explanation to support E&Y's claim that it would be an aid to any delinquency proceedings to stay this matter and submit it to an arbitration order. Arbitration between AIK Comp and E&Y contemplates the very real risk of disparity of judgments resulting from the arbitration and a trial before this Court regarding the remaining defendants.

It is difficult to imagine the confusion and inefficiencies that are certain to arise should the Court retain jurisdiction over all third party causes of action except those where against E&Y. The allegations against this Defendant are closely related to the allegations against David S. Meyer, Stephen P. Lattanzio, Actuarial & Technical Solutions, Inc., former officers and trustees of AIK and AIK, Inc. The same discovery that will be necessary and relevant to E&Y will also be relevant to the other third party defendants, including the same documents and the same witnesses. It makes very little sense to have the Rehabilitator involved in various and differing dispute

resolution proceedings when the claims against the third parties are all directly related.

The salutary purposes of state insurance rehabilitations, of treating all involved fairly, would be circumvented if E&Y is allowed to have its disputes with AIK adjudicated in a manner inconsistent with others. If the Rehabilitator is embroiled in piecemeal litigation and dispute resolution, legal expenses increase dramatically and the estate decreasingly correspondingly.

By retaining exclusive jurisdiction over this matter, the Court will also ensure that the Court can continue its close scrutiny of all aspects of the rehabilitation. It is well within the discretion of both the Rehabilitator and this Court for the Court to retain jurisdiction over the third party actions against E&Y, even though it may interfere with the contractual relations of private parties.

2. Any Enforceable Agreement Against AIK Compelling Arbitration May Not Be Applied To Additional Years

E&Y provided AIK auditing services from 1998 to 2003. The arbitration agreement which E&Y attempt to enforce was applicable only to the years 2001, 2002 and 2003. The Rehabilitator has filed suit against E&Y for its negligence in performing auditing services for AIK for the years ending 1998, 1999, 2000, 2001 and 2002 (E&Y withdrew its engagement with AIK in 2003). Thus the arbitration agreement is completely irrelevant and unenforceable as to any cause of action or dispute that arose between the parties in 1998, 1999 and 2000.

The allegations and counts of negligence, negligent misrepresentation and various statutory violations against E&Y arise from E&Y's work throughout its entire relationship with AIK and cannot be separated.

In *Sec. Watch, Inc. v Sentinel Sys., Inc.*, 176 F.3d 369, 372 (6th Cir. 1999), the Sixth Circuit Court of Appeals held that an arbitration agreement cannot be used to compel arbitration of disputes that arise under prior agreements that do not contain arbitration provisions. If this Court were to enforce the alleged arbitration agreement, it could only do so for the years 2001, 2002 and 2003. This would mean that the disputes regarding these years would be determined by an arbitration and the disputes regarding the years 1998, 1999 and 2000 would be determined by this Court. It would benefit no one for this Court to require the Rehabilitator to prosecute its case against E&Y in two separate dispute resolution forums.

3. The Rehabilitator is Not a Signatory to Any Arbitration Agreement Between AIK and E&Y.

The Rehabilitator is not a party to any agreement to arbitrate. The Rehabilitator did not sign or agree to the arbitration. E&Y seeks to impose that duty because the Rehabilitator assumed the powers of the officers and trustees of AIK. There exist no facts which support commonly recognized reasons for applying a contractual agreement to a nonsignatory.

A party to an arbitration agreement may compel arbitration against a nonsignatory to that arbitration agreement when that party has entered into a separate contractual relationship with the nonsignatory which incorporates the existing arbitration clause. *See*

Import Export Steel Corp. v. Mississippi Valley Barge Line Co., 351 F.2d 503, 505-06 (2d Cir. 1965). There is no evidence to indicate that the Rehabilitator has entered into any separate contractual relationship with E&Y.

In the absence of a signature, a party may be bound by an arbitration clause if its subsequent conduct indicates that it is assuming the obligation to arbitrate. *In re Transrol Navegacao S.A.*, 782 F.Supp. 848, 851 (S.D.N.Y. 1991). The Rehabilitator has done nothing to indicate that she is assuming any obligation to arbitrate this dispute with E&Y.

Traditional principals of agency law may bind a nonsignatory to an arbitration agreement. *See Interbras Cayman* Co. *v. Orient Victory Shipping Co., S.A.*, 663 F.2d 4, 6-7 (2nd Cir. 1981). Because the arbitration agreement was entered into well before the rehabilitation of AIK, the Rehabilitator cannot possibly be bound under an agency theory.

Some courts have recognized an alternative estoppel theory requiring arbitration between a signatory and nonsignatory. *See Sunkist Soft Drinks, Inc. v. Sunkist Growers, Inc.*, I0 F.3d 753, 757 - 58 (11th Cir. 1993). At no point and under no circumstances has the Rehabilitator indicated a willingness to arbitrate. As such, the Rehabilitator cannot be bound by the arbitration agreement under an estoppel theory.

4. The Rehabilitator May Revoke or Rescind Any Existing and Valid Arbitration Agreement Entered into by AIK.

Pursuant to KRS Chapter 304, Subtitle 33 (the "Kentucky Insurance Code"), the Rehabilitator dearly has the exclusive authority to bring civil actions on behalf of AIK Comp against "any officer, manager, agent, employee, or other person" whom the rehabilitator has reason to belief engaged in "tortious conduct or breach of any contractual or fiduciary obligation detrimental to the insurer [AIK Comp]." KRS 304.33-160(4).

The Rehabilitator derives her power to rehabilitate AIK Comp pursuant to KRS 304.33 ("the Kentucky Insurance Code"). This grant is a statutory embodiment of the police powers of the Commonwealth. *See Minor,* 898 S.W.2d at 78 (Ky. 1995) (specifically holding that the authority to rehabilitate an insurer is an aspect of the police powers of the Commonwealth).

The successful rehabilitation of AIK is clearly an important public matter. The Rehabilitator, with supervision from this Court, is taking steps in furtherance of that public interest. "The due process clause does not restrict the state's reasonable exercise of its police power in furtherance of the public interest, even though such laws may interfere with contractual relations and commercial freedoms of private parties." *Minor v. Stephens*, 898 S.W.2d 78, 82 (Ky. 1995). Additionally, the private contracts of those with an interest in the insurer or self-insurance group are "subject to a reasonable exercise of state police

powers." *Kentucky Central Life Ins. Co. v. Stephens*, 897 S.W.2d 583, 587 (Ky. 1995).

In this case, E&Y is attempting to enforce a private contract it had with AIK against the Rehabilitator. KRS 304.33-010(6) specifically subordinates that agreement to this proceeding. In rehabilitating AIK, however, the Rehabilitator is making use of the police powers expressly granted to her by the Commonwealth and this Court, and, as the Kentucky Supreme Court has squarely held, the reasonable exercise of a state's police powers in furtherance of the public interest does not violate the due process rights of any party that may be affected by that exercise. The Rehabilitator, having considered the available options, strongly believes that having this Court retain exclusive jurisdiction over the rehabilitation proceedings, including all third party causes of action, will best serve the public interest in ensuring a successful and efficient rehabilitation of AIK.

5. Federal Law Does Not Preempt State Law.

Generally, arbitration clauses are enforceable under the Federal Arbitration Act ("FAA"). 9 U.S.C. § 3 (1994). However, the McCarran-Ferguson Act ("McCarran-Ferguson"), 15 U.S.C. § 1011 *et seq.*, preserves state statutes enacted "for the purpose of regulating the business of insurance" from preemption and leaves the regulation of the business of insurance to the states. Under McCarran-Ferguson, "[n]o Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance...unless such Act specifically relates to the business of

insurance." 15 U.S.C. § 1012(b) (1994). The McCarran-Ferguson Act establishes an "express federal policy of noninterference in insurance matters" and a clear" [congressional mandate] that regulation of the insurance industry be left to the individual states." *Levy v. Lewis*, 635 F.2d 960, 963 - 964 (2d Cir. 1980).

Because the Kentucky Insurance Code is a state statute enacted "for the purpose of regulating the business of insurance" and is "designed to protect policyholders", McCarran-Ferguson expressly exempts it from preemption by the FAA. Accordingly, the FAA and federal case law interpreting that act, is irrelevant to this action.

Conclusion

There have been very convincing arguments made by the Rehabilitator that the arbitration agreement between AIK and E&Y is not valid and has been voided by the conduct of the parties. Be that as it may, it is very clear to this Court that enforcing any arbitration agreement between an insurer and a third party upon a Rehabilitator will certainly lead to a less organized and unpredictable reorganization pursuant to the Kentucky Insurance Code. The Rehabilitator will be forced into piecemeal litigation in an effort to prosecute actions against those who are responsible for the insurer's financial distress. Such a result is certainly not what the General Assembly intended when it enacted the Kentucky Insurance Code.

Kentucky has enacted comprehensive statutes and rules to regulate the business of insurance, including the rehabilitation of insurance companies and self-insurance groups. Under the Kentucky Insurance Code, the Rehabilitator is vested with title to the

property and contracts of AIK for the benefit of AIK group members, and most importantly for the benefit of injured workers in the Commonwealth who are dependent upon the successful rehabilitation of AIK for the benefits owed to them. The Rehabilitator, which supervision from this Court, is also authorized to exercise exclusive jurisdiction over the rehabilitation estate of AIK.

So ORDERED This 12 day of September, 2007.

Thomas D. Wingate, Judge
Franklin Circuit Division
Division No. II

U.S. Const., Art. VI, cl. 2.

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Ky. Rev. Stat. Ann. § 304.33-010 — Title, construction, and purpose

(1) Short title. This subtitle may be cited as the "Insurers Rehabilitation and Liquidation Law."

(2) Construction. No limitation of powers. This subtitle shall not be interpreted to limit the powers granted the commissioner by other provisions of the law.

(3) Liberal construction. This subtitle shall be liberally construed to effect the purpose stated in subsection (4) of this section.

(4) Purpose. The purpose of this subtitle is the protection of the interests of insureds, creditors, and the public generally, with minimum interference with the normal prerogative of proprietors, through:

(a) Early detection of any potentially dangerous condition in an insurer, and prompt application of appropriate corrective measures, neither unduly harsh nor subject to the kind of publicity that would needlessly damage or destroy the insurer;

(b) Improved methods for rehabilitating insurers, by enlisting the advice and management expertise of the insurance industry;

(c) Enhanced efficiency and economy of liquidation, through the consolidation of matters relating to the liquidation under the supervision of a single court so as to avoid divergent rulings by a multiplicity of judicial

tribunals and through clarification and specification of the law, to minimize legal uncertainty and litigation;

(d) Equitable apportionment of any unavoidable loss;

(e) Lessening the problems of interstate rehabilitation and liquidation by facilitating cooperation between states in the liquidation process, and by extension of the scope of personal jurisdiction over debtors of the insurer outside this state;

(f) Regulation of the insurance business by the impact of the law relating to delinquency procedures and substantive rules on the entire insurance business; and

(g) Provision for a comprehensive scheme for the supervision, rehabilitation, and liquidation of insurance companies and those subject to this subtitle as part of the regulation of the business of insurance, insurance industry, and insurers in this state. Proceedings in cases of insurer insolvency and delinquency shall be deemed an integral aspect of the business of insurance and are of vital public interest and concern.

(5) All persons who voluntarily transact business with an insurer which is subsequently the subject of a delinquency proceeding under this subtitle shall be conclusively presumed to have transacted business with the intent that the provisions of this subtitle would control if there is any delinquency proceeding in this state.

(6) If there is a delinquency proceeding under this subtitle, the provisions of this subtitle shall govern those proceedings, and all conflicting contractual provisions contained in any contract between the insurer which is subject to the delinquency proceeding and any third party shall be deemed subordinated to the provisions of this subtitle. However, notwithstanding the foregoing, in any delinquency proceeding commenced against an insurer after July 15, 1996, nothing in this subtitle shall be construed to subordinate or restrict the rights of parties to submit their disputes to arbitration pursuant to a contractual arbitration clause contained in a reinsurance agreement.

Ky. Rev. Stat. Ann. § 304.33-030 — Definitions.

For the purposes of this subtitle:

(1) "Agent" means all persons who have collected or are holding premiums or other assets of the insurer, including but not limited to brokers, intermediaries, managing general agents, underwriting managers, and reinsurance managers, and any other persons who have entered into a fiduciary relationship with the insurer subject to delinquency proceedings, including but not limited to persons holding licenses under Subtitles 9, 32, 38, and 43 of KRS Chapter 304;

(2) "Commissioner" means the commissioner of the Department of Insurance of this state;

(3) "Receiver" means receiver, liquidator, rehabilitator, or conservator, as the context requires;

(4) "Insurer" has the meaning defined in Subtitle 1 of this chapter. For purposes of this subtitle, all other persons included under KRS 304.33-020 shall be deemed to be insurers;

(5) "Delinquency proceeding" means any proceeding commenced against an insurer for the purpose of liquidating, rehabilitating, reorganizing, or conserving such insurer, and any summary proceeding under KRS 304.33-110 to 304.33-130, inclusive;

(6) "State" has the meaning defined in Subtitle 1 of this chapter;

(7) "Foreign country" means territory not in any state;

(8) "Domiciliary state" means the state in which an insurer is incorporated or organized or, in the case of an alien insurer, the state in which the insurer has, at the commencement of delinquency proceedings, the largest amount of its assets held in trust and on deposit for the benefit of policyholders and creditors in the United States;

(9) "Ancillary state" means any state other than a domiciliary state;

(10) "Reciprocal state" means any state other than this state in which in substance and effect subsection (1) of KRS 304.33-200, subsections (1) and (3) of KRS 304.33- 530, KRS 304.33-540, and KRS 304.33-560 to 304.33-590, inclusive, are in force, and in which provisions are in force requiring that the commissioner be the receiver of a delinquent insurer, and in which some provision exists for the avoidance of fraudulent conveyances and preferential transfers;

(11) "General assets" means all property, real, personal or otherwise, not specifically mortgaged, pledged, deposited or otherwise encumbered for the security or benefit of specified persons or limited classes of persons, and as to specifically encumbered property the term includes all such property or its proceeds in excess of the amount necessary to discharge the sums secured thereby, except as otherwise expressly provided in this subtitle. Assets held in trust and on deposit for the security or benefit of all policyholders or all policyholders and creditors, in more than a single state, shall be treated as general assets;

(12) "Reinsurance intermediary" means any person who acts as a broker in soliciting, negotiating, or procuring the making of any reinsurance contract or binder, or acts as an agent in accepting any reinsurance contract or binder on behalf of an insurer;

(13) "Court" means the Franklin Circuit Court;

(14) "Preferred claim" means any claim with respect to which the law accords priority of payment from the general assets of the insurer;

(15) "Special deposit claim" means any claim secured by a deposit made pursuant to law for the security or benefit of one (1) or more limited classes of persons, but not including any claim secured by general assets;

(16) "Secured claim" means any claim secured by mortgage, trust deed, pledge, deposit as security, escrow or otherwise, but not including special deposit claims or claims against general assets including, but not limited to, claims of setoff, counterclaim, or recoupment against obligations to pay premiums to the insurer. The term also includes claims which have become liens upon specific assets by reason of judicial process, except where they have been invalidated;

(17) "Premium" has the meaning set forth in Subtitle 14 of this chapter;

(18) "Insolvency" means that the insurer is unable to pay its debts or meet its obligations as they mature or that its assets do not exceed its liabilities plus the greater of:

(a) Any capital and surplus required by law to be constantly maintained; or

(b) Its authorized and issued capital stock. For purposes of this subsection, "assets" includes one-half (1/2) of the maximum total assessment liability of the policyholders of the insurer, and "liabilities" includes reserves required by law. For policies issued on the basis of unlimited assessment liability, the maximum total liability, for purposes of determining solvency only, shall be deemed to be that amount that could be obtained if there were one hundred percent (100%) collection of an assessment at the rate of ten (10) mills;

(19) "Fair consideration" is given for property or an obligation:

(a) When in exchange for such property or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or services are rendered or obligation is incurred or an antecedent debt is satisfied; or

(b) When such property or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared to the value of the property or obligation obtained;

(20) "Creditor" is a person having any claim, whether matured or unmatured, liquidated or unliquidated, secured or unsecured, absolute, fixed or contingent;

(21) "Transfer" includes the sale and every other method, direct or indirect, of disposing of or of

parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings. The retention of a security title to property delivered to a debtor shall be deemed a transfer suffered by the debtor;

(22)"Doing business" has the meaning designated in Subtitle 1 of this chapter; and

(23)"Guaranty association" means the Kentucky Insurance Guaranty Association, the Kentucky Life and Health Insurance Guaranty Association and any other similar entity now or hereafter created by the Legislature of this state for the payment of claims of insolvent insurers. "Foreign guaranty association" means any similar entities now in existence in, or hereafter created by the legislature of, any other state.

Ky. Rev. Stat. Ann. § 304.33-040 -- Jurisdiction and venue.

(1) Actions by commissioner. Except as provided in subsection (2) of this section, and subsection (1) of KRS 304.33-230, no delinquency proceeding shall be commenced under this subtitle by anyone other than the commissioner and no court shall have jurisdiction to entertain, hear or determine any proceeding commenced by any other person.

(2) Action by judgment creditors:

(a) The judgment creditors of three (3) or more unrelated judgments may commence proceedings under the conditions and in the manner prescribed in this subsection, by serving notice upon the commissioner and the insurer of intention to file a petition for liquidation under KRS 304.33-190 or 304.33-520. Each of the judgments must:

1. Have been rendered against the insurer by a court in this state having jurisdiction over the subject matter and the insurer;

2. Have been entered more than sixty (60) days before the service of notice;

3. Not have been paid in full;

4. Not be the subject of a valid contract between the insurer and any judgment creditor for payment of the judgment, unless the contract has been breached by the insurer; and

5. Not be a judgment on which an appeal or review is pending.

(b) If any one (1) of the judgments in favor of a petitioning creditor remains unpaid for thirty (30) days after service of the notice, and the commissioner has not then filed a petition for liquidation, the creditor may file in the name of the commissioner a verified petition for liquidation of the insurer under KRS 304.33-190 or 304.33-520 alleging the conditions stated in this subsection. The commissioner shall be served and joined in the action.

(3) Exclusiveness of proceedings.

(a) The court shall have exclusive jurisdiction to entertain, hear, or determine all matters in any way relating to any delinquency proceeding under this subtitle, including but not limited to all disputes involving purported assets of the insurer.

(b) Notwithstanding the provisions of paragraph (a) of this subsection, the court may authorize the receiver to seek injunctive or other appropriate relief from other courts, either within or without this state, if, in the opinion of the court, this action will be an aid to any delinquency proceeding.

(c) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this subtitle. No provisions in this subtitle shall be construed to preclude the court from, on its own motion, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules or to prevent an abuse of process.

(4) Change of venue. Venue for proceedings arising under this subtitle shall be laid initially as specified in the sections providing for such proceedings. All other actions and proceedings initiated by the receiver may be commenced and tried where the delinquency proceedings are then pending, or where venue would be laid by KRS Chapter 452 or other applicable law. All other actions and proceedings against the receiver shall be commenced and tried in the county where the delinquency proceedings are pending. At any time upon motion of any party, venue may be changed by order of the court or the presiding judge thereof to any other Circuit Court in this state, as the convenience of the parties and witnesses and the ends of justice may require. This subsection relates only to venue and is not jurisdictional.

(5) Personal jurisdiction, grounds for. In addition to other grounds for jurisdiction provided by the law of this state, a court of this state having jurisdiction of the subject matter shall have jurisdiction over a person served in an action brought by the receiver of a domestic insurer or an alien insurer domiciled in this state:

(a) If the person served is obligated to the insurer in any way as an incident to any agency or brokerage arrangement that may exist or has existed between the insurer and the agent or broker, in any action on or incident to the obligation;

(b) If the person served is a reinsurer who has at any time issued a contract of reinsurance to an insurer against which a rehabilitation or

liquidation order is in effect when the action is commenced, or is an agent or broker of or for the reinsurer, in any action on or incident to the reinsurance contract;

(c) If the person served is or has been an officer, manager, trustee, organizer, promoter, or person in a position of comparable authority or influence in an insurer against which a rehabilitation or liquidation order is in effect when the action is commenced, in any action resulting from the relationship with the insurer;

(d) If the person served is or was at the time of the institution of the delinquency proceedings holding assets in which the receiver claims an interest on behalf of the insurer;

(e) If the person served has filed a claim against the insurer under the provisions of KRS 304.33-360;

(f) If the person served is otherwise amenable to the exercise of personal jurisdiction by the courts of this state under the provisions of the due process clause of the Fourteenth Amendment to the United States Constitution; or

(g) If the person served is obligated to the insurer in any way in any action on or incident to the obligation.

(6) Service of process.

(a) If personal jurisdiction is authorized by this section, service of process may be made on the

person, or any agent of the person, in the county of this state where he or she may be found, or on the Secretary of State who, for this purpose, shall be deemed to be the statutory agent of the person.

(b) The clerk of the court in which the action is brought shall issue a summons against the defendant named in the complaint. The clerk shall execute the summons by sending by certified mail a true copy to the Secretary of State and shall also mail with the summons an attested copy of the complaint. The Secretary of State shall, within seven (7) days of receipt thereof in his or her office, mail the copy of the summons and complaint to the defendant at the address given in the complaint. The letter shall be posted by certified mail, return receipt requested, and shall bear the return address of the Secretary of State. The clerk shall make the usual return to the court, and, in addition, the Secretary of State shall make a return to the court showing that the acts contemplated by this statute have been performed, and shall attach to his or her return the registry receipt, if any. Summons shall be deemed to be served upon the return of the Secretary of State and the action shall proceed as provided in the Rules of Civil Procedure.

(c) The clerk mailing the summons to the Secretary of State shall mail to him or her, at the same time, a fee of ten dollars ($10), which shall be taxed as costs in the action.

(7) Forum non conveniens. If the court on motion of any party finds that any action commenced under subsection (5) of this section should as a matter of substantial justice be tried in a forum outside this state, the court may enter an order to stay further proceedings on the action in this state.

Ky. Rev. Stat. Ann. § 304.33-140 — Grounds for rehabilitation.

(1) The commissioner may apply by verified petition to the court for an order directing the commissioner to rehabilitate a domestic insurer or an alien insurer domiciled in this state on any one (1) or more of the following grounds:

(a) Any ground on which the commissioner may apply for an order of liquidation under KRS 304.33-190, whenever the commissioner believes that the insurer may be successfully rehabilitated without substantial increase in the risk of loss to creditors of the insurer or to the public;

(b) That the commissioner has reasonable cause to believe that there has been embezzlement from the insurer, wrongful sequestration or diversion of the insurer's assets, forgery or fraud affecting the insurer, or other illegal conduct in, by, or with respect to the insurer, that if established would endanger assets in an amount threatening the solvency of the insurer;

(c) That any one (1) of the following circumstances has occurred and the commissioner has reasonable cause to believe that the insurer is insolvent or that assets are endangered in an amount threatening the solvency of the insurer

1. That information coming into the commissioner's possession has disclosed substantial and not adequately explained discrepancies between the insurer's

records and the most recent annual report or other official company reports;

2. That the insurer has failed to remove any person who in fact has executive authority in the insurer, whether an officer, manager, general agent, employee, or other person, if the person has been found by the commissioner after notice and hearing to be dishonest or untrustworthy in a way affecting the insurer's business;

3. That control of the insurer, whether by stock ownership or otherwise, and whether direct or indirect, is in one (1) or more persons found by the commissioner after notice and hearing to be dishonest or untrustworthy;

4. That any person who in fact has executive authority in the insurer, whether an officer, manager, general agent, employee, or other person, has refused to be examined under oath by the commissioner concerning its affairs, whether in this state or elsewhere, and after reasonable notice of the fact the insurer has failed promptly and effectively to terminate the employment and status of the person and all his or her influence on management;

5. That the insurer has refused to submit its books, accounts, documents, or other records to the reasonable examination or inspection of the commissioner or the commissioner's authorized representative;

(d) That the insurer is or is about to become insolvent;

(e) That the insurer is engaging in a systematic practice of reaching settlements with and obtaining releases from policyholders or third-party claimants and then unreasonably delaying payment of or failing to pay the agreed upon settlements;

(f) That the insurer is in such condition that the further transaction of business would be hazardous, financially or otherwise, to its policyholders, its creditors, or the public;

(g) That within the previous twelve (12) months the insurer has systematically attempted to compromise with its creditors on the ground that it is financially unable to pay its claims in full;

(h) That without first obtaining the written consent of the commissioner, the insurer has transferred, or attempted to transfer, substantially its entire property or business, or has entered into any transaction the effect of which is to merge, consolidate, or reinsure substantially its entire property or business in or with the property or business of any other person;

(i) That the insurer or its property has been or is the subject of an application for the appointment of a receiver, trustee, custodian, conservator, or sequestrator or similar fiduciary of the insurer or its property otherwise than as authorized under this

subtitle, and that such appointment has been made or is imminent, and that such appointment might oust the courts of this state of jurisdiction or prejudice orderly delinquency proceedings under this subtitle;

(j) That within the previous year the insurer has willfully violated its charter or articles of incorporation or any insurance law or regulation of this state, or having become aware within the previous year of an unintentional violation has failed to take all reasonable steps to remedy the situation resulting from the violation and to prevent future violations;

(k) That the directors of the insurer are deadlocked in the management of the insurer's affairs and that the members or shareholders are unable to break the deadlock and that irreparable injury to the insurer, its creditors or its policyholders is threatened by reason thereof;

(l) That the insurer has failed to file its annual report or other report within the time allowed by law, and after written demand by the commissioner has failed to give an adequate explanation immediately; and

(m) That two-thirds (2/3) of the board of directors, or the holders of a majority of the shares entitled to vote, or a majority of members or policyholders of an insurer subject to control by its members or policyholders, consent to rehabilitation under this subtitle.

(2) Upon the issuance of an order directing the commissioner to rehabilitate a domestic insurer, the court shall have exclusive jurisdiction over all matters relating to the rehabilitation, including, but not limited to, the proper scope and application of the provisions of this subtitle to the rehabilitation as well as all interpretation and enforceability of all contracts of insurance to which the insurer is a party.

Ky. Rev. Stat. Ann. § 304.33-160 — Powers and duties of the rehabilitator.

(1) Special deputy. The commissioner as rehabilitator shall appoint one (1) or more special deputies, who are active or retired senior executives from a successful insurer, and who shall have all the powers and responsibilities of the rehabilitator granted under this section, and the commissioner may employ such counsel, clerks, and assistants as deemed necessary. The compensation of the special deputy, counsel, clerks, and assistants and all expenses of taking possession of the insurer and of conducting the proceedings shall be fixed by the commissioner, with the approval of the court and shall be paid out of the funds or assets of the insurer. The persons appointed under this section shall serve at the pleasure of the commissioner. If the property of the insurer does not contain sufficient cash or liquid assets to defray the costs incurred, the commissioner may advance the costs so incurred out of any appropriation for the maintenance of the Department of Insurance. Any amounts so advanced for expenses of administration shall be repaid to the commissioner for the use of the Department of Insurance out of the first available money of the insurer.

(2) General power. The rehabilitator may take action as he or she deems necessary or appropriate to reform and revitalize the insurer. He or she shall have all the powers of the directors, officers, and managers, whose authority shall be suspended, except as they are redelegated by the rehabilitator. He or she shall have full power to direct and manage, to hire and discharge employees subject to

any contract rights they may have, and to deal with the property and business of the insurer.

(3) Advice from experts. The rehabilitator may consult with and obtain formal or informal advice and aid of insurance experts.

(4) Pursuit of insurer's claims against insiders. If the rehabilitator finds that there has been criminal or tortious conduct or breach of any contractual or fiduciary obligation detrimental to the insurer by any officer, manager, agent, employee, or other person, he or she may pursue all appropriate legal remedies on behalf of the insurer.

(5) Reorganization plan. The rehabilitator may prepare a plan for the reorganization, consolidation, conversion, reinsurance, merger, or other transformation of the insurer. Upon application of the rehabilitator for approval of the plan, and after the notice and hearing as the court prescribes, the court may either approve or disapprove the plan proposed, or may modify it and approve it as modified. If it is approved, the rehabilitator shall carry out the plan. In the case of a life insurer, the plan proposed may include the imposition of liens upon the equities of policyholders of the insurer, if all rights of shareholders are first extinguished. A plan for a life insurer may also propose imposition of a moratorium upon loan and cash surrender rights upon policies, for such period and to such an extent as are necessary.

(6) Fraudulent transfers. The rehabilitator shall have the power to avoid fraudulent transfers under KRS 304.33-290 and 304.33-300.

Appendix E

COMMONWEALTH OF KENTUCKY
FRANKLIN CIRCUIT COURT
SECOND DIVISON

No. 05-CI-455

MARTIN J. KOETTERS. EXECUTIVE PLAINTIFF, DIRECTOR, KENTUCKY OFFICE OF INSURANCE AS REHABILITATOR OF AIK COMP, FOR AND ON BEHALF OF AIK COMP

Plaintiff,

vs.

ERNST & YOUNG LLP, ET AL.

Defendants.

Affidavit of David S. Meyer

STATE OF OHIO
COUNTY OF HAMILTON
SS:

I, David S. Meyer, being duly sworn and cautioned and with personal knowledge of the facts, hereby depose and state as follows:

1. I am a partner in Ernst & Young LLP.

2. Attached to this affidavit as Exhibit A is a true and accurate copy of an engagement letter between AIK Comp and Ernst & Young, LLP as retrieved from the files of Ernst & Young LLP.

FURTHER AFFIANT SAYETH NAUGHT

_____

David S. Meyer

Sworn to and subscribed before me this 18 day of April, 2005.

_____

Notary Public (Amy M. Conner)

My Commission Expires: 12/25/06

EXHIBIT A

ERNST & YOUNG
Ernst & Young llp is a member of Ernst & Young International, Ltd.

1300 Chiquita Center
250 East Fifth Street
Cincinnati, Ohio 45202
Phone: (513) 621-6454
www.ey.com

July 22, 2002

Mr. Maurice Turner
CEO
AIK Comp
2200 Greene Way
Suite 201
Louisville, Kentucky 40220

Dear Mr. Turner:

This will confirm our engagement letter signed in 2001 to audit and report on the financial statements of AIK Comp (AIK) for the years ending December 31, 2001 through December 31, 2003, and to prepare and sign the Company's U.S. federal and Louisville/Jefferson County (OL-3) income tax returns for the years then ended and to provide a compliance review of all state and local issues that may impact the Fund (e.g., intangible tax compliance).

Should conditions not anticipated prelude us from completing our audits and issuing the reports as contemplated by the preceding paragraph, we will advise you and the audit committee promptly and take such action, as we deem appropriate.

Our estimated audit fees for the 2002 audit are $56,825, which includes expenses. The estimated tax return review fees are $5,850 plus expenses not to exceed 10% of the base fee. These fee estimates are based on anticipated hours with strong client assistance and no unusual or new items or significant errors noted. To the extent that time is incurred in excess of anticipated hours (for instance, due to client assistance deficiencies, significant audit issues requiring additional time commitments, or similar situations), we will discuss additional billings for the excess time at a blended hourly rate.

For the audit year ending December 31, 2002, we will submit our invoices according to the following schedule and payment of them should be made upon receipt. We will provide you a schedule of invoice information for 2003 at the beginning of that audit year.

November 1, 2002	$27,000
February 28, 2003	$29,825
May 15, 2003 (50% tax progress bill)	$2,925
Invoiced and payable upon completion of tax return	$2,925 (plus expenses)

Any controversy or claim arising out of or relating to services covered by this letter or here-after provided by u s for the Fund or at its request (including any such matter involving any parent, subsidiary, affiliate, successor in interest, or agent of the Fund or of Ernst & Young LLP, or involving any person or entity for whose benefit the services in question are or were provided), shall be submitted first to voluntary mediation, and if mediation is not successful, then to binding arbitration, in accordance with the dispute

resolution procedures set forth in the attachment to this letter. Judgment on any arbitration award many be entered in any court having jurisdiction.

If these arrangements are acceptable, please sign this letter and return it to us at your earliest convenience.

Maurice, Larry Johnson and I very much appreciate the opportunity to serve the AIK account. We would be pleased to furnish any additional information you may request concerning our responsibilities and functions.

Very truly yours,

David S. Meyer
Partner

AIK Comp

By: _____
Mr. Maurice Turner
Chief Executive Officer

7/29/02 _____
Date

Dispute Resolution Procedures

The following procedures shall be used to resolve any controversy or claim ("dispute") as provided in our engagement letter of July 22, 2002. If any of these provisions are determined to be invalid or unenforceable, the remaining provisions shall remain in effect and binding on the parties to the fullest extent permitted by law.

Mediation

A dispute shall be submitted to mediation by written notice to the other party or parties. The mediator shall be selected by agreement of the parties. If the parties cannot agree on a mediator, a mediator shall be designated by the CPR Institute for Dispute Resolution at the request of a party. Any mediator so designated must be acceptable to all parties.

The mediation shall be conducted as specified by the mediator and agreed upon by the parties. The parties agree to discuss their differences in good faith and to attempt, with facilitation by the mediator, to reach an amicable resolution of the dispute. The mediation shall be treated as settlement discussion and therefore shall be confidential. The mediator may not testify for either party in any later proceeding relating to the dispute. No recording or transcript shall be made of the mediation proceedings.

Each party shall bear its own costs in the mediation. The fees and expenses of the mediator shall be shared equally by the parties.

Arbitration

If a dispute has not been resolved within 90 days after the written notice beginning the mediation process (or a longer period, if the parties agree to extend the mediation), the mediation shall terminate and the dispute shall be settled by arbitration. The arbitration will be conducted in accordance with the procedures in this document and the Rules for Non-Administered Arbitration of the CPR Institute for Dispute Resolution ("Rules") as in effect on the date of the engagement letter, or such other rules and procedures as the parties may designate by mutual agreement. In the event of a conflict, the provisions of this document will control.

The arbitration will be conducted before a panel of three arbitrators, two of whom are to be designated by the parties from the CPR Panel of Distinguished Neutrals using the screened selection process provided in the Rules. Any issue concerning the extent to which any dispute is subject to arbitration, or concerning the applicability, interpretation, or enforceability or these procedures, including any contention that all or part of these procedures are invalid or unenforceable, shall be governed by the Federal Arbitration Act and resolved by the arbitrators. No potential arbitrator shall be appointed unless he or she has agreed in writing to abided and be bound by these procedures.

The arbitration panel shall have no power to award non-monetary or equitable relief of any sort. It shall also have no power to award (a) damage3s inconsistent with any applicable agreement between the parties or (b) punitive damages or any other damages not measured by the prevailing party's actual

damages; and the parties expressly waive their right to obtain such damages in arbitration or in any other forum. In no event, even if any other portion of these provisions is held to be invalid or unenforceable, shall the arbitration panel have power to make an award or impose a remedy that could not be made or imposed by a court deciding the matter in the same jurisdiction.

Discovery shall be permitted in connection with the arbitration only to the extent, if any, expressly authorized by the arbitration panel upon a showing of substantial need by the party-seeking discovery.

All aspects of the arbitration shall be treated as confidential. The parties and the arbitration panel may disclose the existence, content or results of the arbitration only as provided in the Rules. Before making any such disclosure, a party shall give written notice to all other parties and shall afford such parties a reasonable opportunity to protect their interests.

The result of the arbitration will be binding on the parties, and judgment on the arbitration award may be entered in any court having jurisdiction.